This guidance is as adopted by the NAIC as of March 2005. Please note that there will be modifications to the accounting pronouncements included in this manual from year to year as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing the holder of this manual with the latest information impacting statutory accounting. The holder of this manual may enter a password-protected NAIC website and download an Issue Paper, Statement of Statutory Accounting Principles, Appendix or Interpretation finalized in 2005 that affects this manual. This website will also include the latest minutes of the Statutory Accounting Principles Working Group and the Emerging Accounting Issues Working Group. Should you wish to be notified via e-mail by the NAIC when the password-protected website is updated, you can visit the website listed below and click the link to sign up for e-mail notification of updates to the statutory accounting website. The NAIC will retain the 2004 database; therefore, if you were receiving notifications via e-mail in 2004, there is no need to resubmit your request in 2005.


User ID:  ACCOUNTING  (enter exactly as presented – case sensitive)
Password:  2005SAP  (enter exactly as presented – case sensitive)

Password Information (although not unique to user, this password should only be used by persons who have obtained the March 2005 Accounting Practices and Procedures Manual from the NAIC).
How to Use This Manual

How This Manual is Arranged …

The contents of this Manual are arranged as follows:

Volume I:

- Summary of Changes
- Table of Contents
- Preamble
- Statements of Statutory Accounting Principles
- Index to the Statements of Statutory Accounting Principles
- Glossary
- Appendix A – Excerpts of NAIC Model Laws
- Appendix B – Interpretations of the Emerging Accounting Issues Working Group
- Appendix C – Actuarial Guidelines
- Appendix D – GAAP Cross-Reference to SAP

Volume II:

- Appendix E – Issue Papers
- Appendix F – Policy Statements

The arrangement of material as indicated above is included in the Table of Contents at the front of each Volume. There is also a detailed Table of Contents covering the material within each section immediately preceding such section.

Summary of Changes:

This section provides a summary of the changes that were made to the As of March 2004 version of the Accounting Practices and Procedures Manual to create the As of March 2005 version. This summary is separated into two sections. The first section summarizes the nonsubstantive changes to the Manual. Nonsubstantive changes are characterized as language clarifications which do not modify the original intent of a SSAP, or changes to reference material. These nonsubstantive changes are depicted by underlines (new language) and strike-throughs (removed language) in the applicable SSAP and will not be shown as marked in subsequent manuals. The second section summarizes the substantive revisions to the Manual. These substantive revisions introduce original or modified accounting principles and, therefore, are depicted with new SSAPs. Should a new SSAP supersede an existing SSAP, the superseded language is noted and the reader is referred to the new SSAP. In addition, language that is superseded is shaded in the text of the SSAP.

Preamble:

Each and every user of the Manual should read this section. Many regulators consider this document one of the most important parts of the Manual as it provides the foundation for statutory accounting principles (SAP). Some of the significant topics covered in the Preamble include Codification Project Background, statement of concepts, statutory hierarchy, materiality and disclosures.

Statements of Statutory Accounting Principles:

As indicated by the Statutory Hierarchy, the Statements of Statutory Accounting Principles (SSAPs) are the primary Accounting Practices and Procedures promulgated by the NAIC. These statements are the result of issue papers that have been exposed for public comment and finalized. Finalized issue papers are in Appendix E and ARE NOT authoritative. While it is not intended that there be any significant differences between an underlying issue paper and the resultant
SSAP, if differences exist, the SSAP prevails and shall be considered definitive. Readers may use the NAIC website, as indicated on the inside front cover of the Manual, to keep abreast of substantive and nonsubstantive changes to the SSAPs.

The cover page of each SSAP contains a STATUS section that can affect the implementation of each SSAP. The STATUS section contains the following:

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

**ISSUED** – Date when the SSAP was adopted by the NAIC. SSAPs designated with Initial Draft were adopted by the NAIC Plenary in March 1998 as part of the Codification Project (SSAPs No. 1 to 73). The date included for SSAP No. 74, and subsequent SSAPs, denotes when the Statutory Accounting Principles Working Group adopted the SSAP.

**EFFECTIVE DATE** – Date representing when the SSAP is effective. Many times there are additional details relative to the transition provided within the SSAP.

**AFFECTS/AFFECTED BY** – Once an SSAP has been promulgated it will only be substantively amended or superseded through the issuance of a new SSAP. A useful tool for tracking of the relationships between statements is contained within this section of the SSAP. Readers are referenced to another SSAP at the “affected by” line if the SSAP has been substantively amended or superseded. Text within paragraphs substantively amended or superseded are also “shaded” to notify readers that revised guidance is available. The “affects” section is used by SSAPs that substantively amend or supersede previously issued SSAPs.

**INTERPRETED BY** – This section includes a reference to the applicable Interpretation (INT) of the Emerging Accounting Issues Working Group contained within Appendix B of the Manual provide interpretative guidance as a result of issues raised by users of the Manual or related GAAP guidance. INTs are generally effective when adopted. Readers should note that the Manual only contains the INTs finalized through December 2004 due to the fact that the Manual is published annually. Readers may use the NAIC website, as indicated on the inside front cover of the Manual, to keep abreast of recently issued INTs.

**Appendix A – Excerpts of NAIC Model Laws:**
In most cases, the source document for information included in Appendix A is an NAIC Model Regulation or Law. These Appendices are referenced by specific SSAPs and should only be used in context of the Appendix and the SSAP that references it.

**Appendix B – Interpretations of the Emerging Accounting Issues Working Group:**
The Emerging Accounting Issues Working Group (EAIWG) is responsible for responding to SAP questions that generally relate to application, interpretation and clarification. Appendix B includes the final interpretations of the EAIWG through December 5, 2004. Each of the SSAPs includes a reference to the applicable INT once it has been finalized.

**Appendix C – Actuarial Guidelines:**
The NAIC Life and Health Actuarial Task Force has been asked on many occasions to assist a particular state insurance department in interpreting a statute dealing with an actuarial topic relative to an unusual policy form or situation not contemplated at the time of original drafting of
How to Use This Manual

a particular statute. The Life and Health Actuarial Task Force, in developing its interpretation or
guideline, must often consider the intent of the statute, the reasons for initially adopting the
statute and the current situation. The Life and Health Actuarial Task Force feels that for those
situations which are sufficiently common to all states, the publishing of actuarial guidelines on
these topics would be beneficial to the regulatory officials in each state and would promote
uniformity in regulation which is beneficial to everyone. To this end, the Life and Health
Actuarial Task Force has developed certain actuarial guidelines and will continue to do so as the
need arises. The guidelines are not intended to be viewed as statutory revisions but merely a
guide to be used in applying a statute to a specific circumstance.

Appendix D – GAAP Cross-Reference to SAP:
As expressed in the Statement of Concepts, SAP utilizes the framework established by Generally
Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that
have been considered in the development of SAP and include all issued pronouncements in
categories a, b and c of the GAAP Hierarchy. This listing includes GAAP pronouncements
issued through December 2004 (September 30, 2004 for Opinions of the FASB Emerging Issues
Task Force (EITF)). This Appendix is a valuable and efficient tool for readers who are interested
in the status of a particular GAAP pronouncement in the SAP model.

Appendix E – Issue Papers:
This section includes all of the issue papers associated with SSAPs adopted by the Statutory
Accounting Principles Working Group through December 2004. The issue papers are used as the
first step in developing new SSAPs and contain a recommended conclusion, discussion and
relevant literature section. Issue Papers DO NOT constitute an authoritative level of statutory
accounting, as supported by the statutory hierarchy, and should only be used as reference
material. Nevertheless, issue papers are an important part of the Manual because they reference
the history and discussion of the related SSAP. The Relevant Statutory Accounting and GAAP
Guidance section of the issue paper contains excerpts of accounting guidance in place at the time
the Statutory Accounting Principles Working Group considered (but not necessarily adopted) in
forming the conclusions reached in the resultant SSAP.

Appendix F – Policy Statements:
This section includes the NAIC Policy Statements applicable to SAP. These statements provide
the basis by which SAP is maintained, documentation of the agenda process and other important
issues that affect this Manual.

How to Use this Manual …

... to account for a certain item under NAIC SAP
As the SSAPs represent the highest level of NAIC statutory authority, readers should begin their
search there. The Index to SSAPs is a useful tool to identify which SSAP(s) address the issue.
Once the pertinent SSAP has been identified, it can be used to locate other documents that may
also address the issue. On the SSAP cover page, readers will be referred to other SSAPs if there
have been substantive changes made to it or INTs if there have been interpretations of the SSAP.
Within the body of the SSAP, readers may be referred to Appendix A or C for further guidance.
There is a reference located at the end of each SSAP to issue paper(s) used in the development of
the SSAP. The DISCUSSION section of the issue paper provided documentation supporting the
conclusions reached in the SSAP. As supported by the statutory hierarchy, readers should only
utilize the issue papers as support to the SSAP as they ARE NOT authoritative. The Statutory
Hierarchy contains a detailed listing of levels of authoritative literature.

... to compare SAP to GAAP for a particular issue
Appendix D is an excellent reference for users who are interested in determining how SAP
addresses an issue that has been adopted by GAAP. Appendix D provides a reference to the
How to Use This Manual

SSAP or INT that addresses a particular GAAP pronouncement. As indicated in the Preamble, users should not utilize GAAP until and unless adopted by the NAIC. Within the body of the applicable SSAP or INT, readers will find documentation as to the reason for adoption, rejection, or adoption with modification of a particular GAAP pronouncement.

... to identify the relationship between the Manual and State law

Once a reader has identified the accounting treatment for a particular transaction or issue within the Manual, one must consider the effect of state law. That is, this Manual is not intended to preempt states’ legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to if not in conflict with state statutes and/or regulations, or when the state statutes and/or regulations are silent. For instance, if a state prohibits the admission of goodwill, insurers domiciled in that state are required to nonadmit all goodwill instead of following the NAIC guidance contained within SSAP No. 68—Business Combinations and Goodwill. Insurers should refer to their state laws and regulations regarding deviations from this Manual.

... to obtain updates to the latest published Manual

This Manual contains information as of December 2004. Please note that there will be modifications to the accounting pronouncements included in this Manual from year to year, as such guidance is subject to the maintenance process. To address this, the NAIC has a website dedicated to providing the holder of this Manual with the latest information impacting statutory accounting. The holder of this Manual may enter a password-protected NAIC website and download an Issue Paper, Statement of Statutory Accounting Principles, Appendix or Interpretation that affects this Manual. This website will also include the latest minutes of the Statutory Accounting Principles Working Group and the Emerging Accounting Issues Working Group. Further details can be found on the inside front cover of this Manual.

... to learn how changes get made to the Manual and how to stay abreast of such changes

Appendix F contains several NAIC Policy Statements that document the process by which this Manual will be modified. It also outlines the process by which the Statutory Accounting Principles and the Emerging Accounting Issues Working Groups will conduct their business. Readers are able to track the development of SAP by attending the quarterly meetings of the working groups or through use of the NAIC website. Further details regarding the website can be found at www.naic.org.

... to contact the NAIC regarding questions about the Manual

The following NAIC staff persons may be contacted regarding questions about this Manual:

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Issue</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robin Marcotte</td>
<td>Life Accountant</td>
<td>Life Accounting</td>
<td>(816) 783-8415</td>
<td><a href="mailto:rmarcott@naic.org">rmarcott@naic.org</a></td>
</tr>
<tr>
<td>SVO</td>
<td>P&amp;C Insurance Accountant</td>
<td>P&amp;C Accounting</td>
<td>(816) 783-8124</td>
<td></td>
</tr>
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<tr>
<td>Statutory Accounting</td>
<td>Annual Statement</td>
<td>SVO P&amp;P Manual</td>
<td>(646) 223-2550</td>
<td><a href="mailto:SVOinquirydesk@naic.org">SVOinquirydesk@naic.org</a></td>
</tr>
<tr>
<td>and Reporting Help</td>
<td>Reporting And Statutory</td>
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<td>Line</td>
<td>Accounting</td>
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<tr>
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<td></td>
<td>(816) 783-8400</td>
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</tbody>
</table>
Summary of Changes to the As of March 2004 Version of the Accounting Practices and Procedures Manual included in the As of March 2005 Version

The following represents a summary of the changes that were made to the As of March 2004 version of the Accounting Practices and Procedures Manual to create the As of March 2005 version. This summary is separated into two sections. The first section summarizes the nonsubstantive changes to the Manual. Nonsubstantive changes are characterized as language clarifications which do not modify the original intent of a SSAP, or changes to reference material. These nonsubstantive changes are depicted by underlines (new language) and strike-throughs (removed language) in the applicable SSAP and will not be shown as marked in subsequent manuals. The second section summarizes the substantive revisions to the Manual. These substantive revisions introduce original or modified accounting principles and, therefore, are depicted with new SSAPs. Should a new SSAP supersede an existing SSAP, the superseded language is noted and the reader is referred to the new SSAP.

Nonsubstantive Modifications

<table>
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<tr>
<td>Preamble</td>
<td>Modified to include Board-directed FASB Staff Positions into NAIC Hierarchy and add the advance notice requirement when a state regulatory authority is considering approval of a permitted practice.</td>
</tr>
<tr>
<td>SSAP No. 1</td>
<td>Expanded reporting requirements to include disclosure if a company’s risk-based capital would have triggered a regulatory event had it not used a permitted practice.</td>
</tr>
<tr>
<td>SSAP No. 21</td>
<td>Clarified that structured settlement annuities discussed in SSAP No. 65, paragraph 17a. are admitted assets.</td>
</tr>
<tr>
<td>SSAP No. 22</td>
<td>Clarified statutory accounting guidance regarding sales-leaseback transactions involving real estate.</td>
</tr>
<tr>
<td>SSAP No. 25</td>
<td>Incorporated the rebuttable presumption of control guidance consistent with SSAP No. 88.</td>
</tr>
<tr>
<td>SSAP No. 26</td>
<td>Modified to correct references to other NAIC publications and clarify accounting treatment of unrealized gains and losses.</td>
</tr>
<tr>
<td>SSAP No. 30</td>
<td>Modified to correct references to other NAIC publications and clarify accounting treatment of exchange traded funds and investments in unaffiliated common stocks.</td>
</tr>
<tr>
<td>SSAP No. 32</td>
<td>Modified to correct references to other NAIC publications and clarify accounting treatment of redeemable preferred stocks designated highest-quality and high-quality (NAIC designations RP1 and RP2, respectively) and unrealized gains and losses.</td>
</tr>
<tr>
<td>SSAP No. 41</td>
<td>Clarified treatment of non-rated surplus notes and changed language in paragraph 10 from “a company action level event” to “any company action level event”.</td>
</tr>
<tr>
<td>SSAP No. 43</td>
<td>Modified to correct references to other NAIC publications and add language to provide consistency and clarity in the IMR treatment of asset backed securities.</td>
</tr>
<tr>
<td>SSAP No. 48</td>
<td>Incorporated the rebuttable presumption of control guidance consistent with SSAP No. 88.</td>
</tr>
<tr>
<td>SSAP No. 50</td>
<td>Added language for classification of funding arrangements with purchase rate guarantees.</td>
</tr>
<tr>
<td>SSAP No. 55</td>
<td>Changed disclosure requirements for asbestos and environmental claims and loss adjustment expenses from a gross basis to a direct and assumed basis.</td>
</tr>
<tr>
<td>SSAP No. 59</td>
<td>Added reference to A-818 in paragraph 20.</td>
</tr>
<tr>
<td>SSAP No. 65</td>
<td>Changed disclosure requirements for asbestos and environmental claims and loss adjustment expenses from a gross basis to a direct and assumed basis. Updated the language in paragraph 15d to ensure consistency with terms used in SSAP No. 55.</td>
</tr>
<tr>
<td>SSAP No. 80</td>
<td>Deleted references to A-825 in paragraph 5, 6 and 8.</td>
</tr>
<tr>
<td>SSAP No. 89</td>
<td>Incorporated pension illustrations and clarified disclosure requirements along with guidance for when a pension liability should be accrued.</td>
</tr>
<tr>
<td>Section</td>
<td>Description</td>
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<td>---------</td>
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</tr>
<tr>
<td>Index</td>
<td>Index to the Manual was updated. These updates have not been “marked” as changes.</td>
</tr>
<tr>
<td>A-001</td>
<td>Reflected changes to the Investment Interrogatories that were approved and incorporated into the Blanks and Annual Statement Instructions during 2004. These updates have not been “marked” as changes in the appendix.</td>
</tr>
<tr>
<td>A-818</td>
<td>Provided guidance for credit life insurance liabilities.</td>
</tr>
<tr>
<td>A-825</td>
<td>This section was deleted to be consistent with NAIC Model Laws. Appropriate guidance for annuity reserve valuation methods can be found in Appendix C.</td>
</tr>
<tr>
<td>A-830</td>
<td>Modified to allow for the use of the 2001 CSO table.</td>
</tr>
<tr>
<td>Appendix B</td>
<td>Updated to include interpretations finalized by the Emerging Accounting Issues Working Group through December 5, 2004. The new INTs include: INT 01-31 as amended; INT 02-09; INT 03-17; and INT 04-01 through INT 04-17 (except for INT 04-16 as this item was rejected). This year, SSAP No. 88 and SSAP No. 91 nullified INT 99-02, INT 99-03, INT 99-28, INT 00-01, 01-04, INT 01-22 and INT 01-24.</td>
</tr>
<tr>
<td>Appendix C</td>
<td>The Appendix to the Actuarial Guidelines has been updated. These updates have not been “marked” as changes in the appendix.</td>
</tr>
<tr>
<td>Appendix D</td>
<td>Listing updated to reflect current status of GAAP pronouncements as of December 2004 (Sept. 30, 2004 for Opinions of the FASB Emerging Issues Task Force). These updates have not been “marked” as changes in the appendix.</td>
</tr>
<tr>
<td>Appendix E</td>
<td>Reflects nonsubstantive modifications made to Issue Paper No. 99 for GAAP guidance rejected by the Statutory Accounting Principles Working Group as not applicable to statutory accounting through December 6, 2004.</td>
</tr>
<tr>
<td>Appendix F</td>
<td>Reflects nonsubstantive changes made to policy statements to address procedures for reviewing existing interpretations when new SSAPs are developed, modify the due date for comment letters and incorporate the new procedures of the Blanks Working Group.</td>
</tr>
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### Substantive Modifications

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<td>SSAP No. 18</td>
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<tr>
<td>SSAP No. 32</td>
<td>SSAP No. 88 superseded the title of this statement along with paragraphs 2 and 3.</td>
</tr>
<tr>
<td>SSAP No. 33</td>
<td>Superseded by SSAP No. 91</td>
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<td>SSAP No. 45</td>
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<td>SSAP No. 46</td>
<td>Superseded by SSAP No. 88</td>
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<tr>
<td>SSAP No. 68</td>
<td>SSAP No. 88 superseded paragraphs 4 through 6.</td>
</tr>
<tr>
<td>SSAP No. 88</td>
<td>New SSAP that provides statutory accounting guidance for subsidiary, controlled and affiliated entities as modified for subsequent non-substantive changes to include SSAP No. 16 and SSAP No. 79 in the list of guidance to follow when calculating statutory adjustments to GAAP equity.</td>
</tr>
<tr>
<td>SSAP No. 91</td>
<td>New SSAP that provides statutory accounting guidance for transfers and servicing of financial assets and extinguishments of liabilities as modified for subsequent non-substantive changes to incorporate previously revised language from SSAP No. 18 and clarify transition guidance.</td>
</tr>
<tr>
<td>IP No. 118</td>
<td>New issue paper that provides background information and support for SSAP No. 88.</td>
</tr>
<tr>
<td>IP No. 122</td>
<td>New issue paper that provides background information and support for SSAP No. 91.</td>
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Appendix E

Introduction

Appendix E includes all of the issue papers associated with SSAPs adopted through March 2005. The issue papers are used as the first step in developing new SSAPs and contain a recommended conclusion, discussion and relevant literature section. While the issue papers do not constitute an authoritative level of statutory accounting guidance, as defined by the statutory hierarchy, they are an important part of this Manual because they reference the history and discussion of the related SSAP.

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Statutory Issue Paper No. 1
Consolidation of Majority-owned Subsidiaries

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Currently, statutory reporting entities do not consolidate the financial statements of a majority-owned subsidiary in their annual statement filing. Investments in majority-owned subsidiaries are reported in Schedule D of the Annual Statement as other investments of a similar type (e.g., common stock and preferred stock) and are valued in accordance with the procedures outlined in the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures). Current GAAP guidance is not consistent with this position and requires consolidation of majority-owned subsidiaries.

SUMMARY CONCLUSION

2. The policy of not consolidating majority owned subsidiaries for individual entity statutory reporting is consistent with the recognition concept included in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts), therefore formal codification of such practice is recommended. The current statutory practice for recording the investment in majority-owned subsidiaries is also an accepted statutory accounting practice by all states.

3. Certain reporting entities who are members of an affiliated group may be required to prepare and issue consolidated or combined annual statements as supplemental information. These statements shall be prepared in accordance with NAIC guidelines.

DISCUSSION

4. The policy of not consolidating majority-owned subsidiaries is consistent with the Recognition concept included in the Statement of Concepts. This concept states that one objective of statutory reporting is to reflect an entity’s ability to meet its policyholder obligations with the existence of readily marketable assets available when both current and future obligations are due. With an investment in subsidiaries, the cash flow generated by the investee may not be available to satisfy policyholder obligations. Therefore the asset that is readily marketable is the shares of ownership (e.g., common or preferred stock).

5. Other issue papers address specific statutory accounting principles which will be used in recording a reporting entity’s investment in insurance and non-insurance affiliates.

Drafting Notes/Comments
- Valuation of the investment in subsidiaries and the reporting of the related income or loss as described in Chapter 6 of the Life APP and Chapter 5b in the SVO Purposes and Procedures is addressed in another issues paper.
- Subsidiary is defined in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
6. Statutory accounting guidance defines a subsidiary, controlled, or affiliated (“SCA”) entity in terms of controlling ownership in an entity’s voting capital stock. Ownership of more than 50% provides “undisputed control” and when 50% or less of the outstanding stock is owned, “control is dependent upon the influence that the owner of that block of stock may have on the other holders of outstanding capital stock.” Relevant guidance states that “Investments in SCA companies include debt security loans and preferred and common stock. In general, the accounting for each type of investment is the same as it would be for any other bond, preferred stock, or common stock investment except that there are some special valuation considerations.” This precludes consolidation of subsidiaries for individual entity statutory reporting purposes.

Generally Accepted Accounting Principles
7. FAS 94 paragraph 13 (amending ARB 51 paragraphs 2 and 3), states:

2. The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmental imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary).

3. All majority-owned subsidiaries—all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest—shall be consolidated except those described in the last sentence of paragraph 2.

RELEVANT LITERATURE

Statutory Accounting
– Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and Property/Casualty Insurance Companies - Chapter 6 Investments in Subsidiary, Controlled or Affiliated Companies
– Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners Manual - Chapter 5b Common Stocks of Subsidiary, Controlled or Affiliated Companies

Generally Accepted Accounting Principles
– FASB Statement No. 94 (FAS 94), Consolidation of All Majority-Owned Subsidiaries
– Accounting Research Bulletin No. 51 (as amended by FAS 94), Consolidated Financial Statements

State Regulations
No accounting guidance was noted in the state regulations.
Statutory Issue Paper No. 2
Definition of Cash

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance limits the classification of cash to include only "a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor’s account.” The statutory guidance also allows “temporary investments in the form of saving accounts and nonnegotiable certificates of deposit in qualified banks and trust companies” to be classified as cash. Nonnegotiable certificates of deposit are instruments whose title may only be transferred upon the agreement of the affected parties to the terms and conditions of the transfer and not upon endorsement and delivery or delivery alone.

2. Additionally, current statutory practice allows reporting of negative cash as a negative asset. This treatment is consistent with the conservatism concept discussed in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Cash Definition
3. Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor’s account. Also classified as cash for financial statement purposes, although not falling within the above definition of cash, are savings accounts and certificates of deposit in banks or other similar financial institutions with maturity dates in one year or less from the acquisition date and cash equivalents. Cash equivalents are short-term, highly liquid investments that are both (a) readily convertible to known amounts of cash, and (b) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Only investments with original maturities of three months or less qualify under this definition.

Treatment of Negative Cash Balances
4. If a reporting entity has multiple cash accounts, the net amount of all such accounts shall be reported jointly. Cash accounts with positive balances shall not be reported separately from cash accounts with negative balances. If in the aggregate, the reporting entity has a net negative cash balance, this amount shall be reported as such in the annual statement and shall not be recorded as a liability.

DISCUSSION

5. As stated in the Statement of Concepts, “the cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders.” Additionally, it states “the ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” The definition of cash is consistent with the Statement of Concepts. Those instruments not included in the definition of cash (e.g., commercial paper and overnight repurchase agreements in excess of 3 months) shall be shown separately as short-term investments.

6. Treating all certificates of deposit with maturity dates in one year or less from the financial statement date as cash is a change from current statutory accounting. This change was made to address
inconsistencies in the guidance between the Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and Life and Accident and Health Insurance Companies (P&C and Life/A&H Accounting Practices and Procedures Manuals) and The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures). The P&C and Life/A&H Accounting Practices and Procedures Manuals require all nonnegotiable certificates of deposit to be classified as cash and negotiable certificates of deposit to be classified as short-term investments or bonds depending on the length to maturity at acquisition. The SVO Purposes and Procedures requires both negotiable and nonnegotiable certificates of deposit to be submitted to the SVO and valued under the general provisions for valuing bonds.

7. The treatment of recording negative cash as a negative asset in the statutory balance sheet follows the concept of conservatism as many regulatory limitations are calculated based upon total admitted assets.

Drafting Notes/Comments
- Funds classified as cash which are not immediately available for the benefit of policyholders (i.e., restricted cash, trust accounts, etc.) is addressed in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets.
- Treatment of drafts issued and drafts honored will be addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. Existing statutory accounting guidance specifically addresses assets qualifying for treatment and classification as cash. Statutory accounting classifies certain assets as being either cash, short-term or long-term investments. The P&C Accounting Practices and Procedures Manual defines cash as follows:

The asset must be a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor’s account. Also classified for financial statement purposes, although not falling within the above description of cash, are temporary investments in the form of saving accounts and nonnegotiable certificates of deposit in qualified banks and trust companies.

There is a similar definition of cash in the Life/A&H Accounting Practices and Procedures Manual.

9. Section 2(C)(7) of the SVO Purposes and Procedures indicates the following requirements for certificates of deposit: “Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).”

Generally Accepted Accounting Principles
10. GAAP adds a “cash equivalent” category for instruments classified as cash. GAAP literature defines a cash equivalent to be short-term, highly liquid investments that are readily convertible to known amounts of cash and are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 5
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 5
- Accounting Practices and Procedures (EX4) Task Force Minutes
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 2
- NAIC Annual Statement Instructions

**Generally Accepted Accounting Principles**

**State Regulations**
- North Carolina Insurance Department Directive 92-D-2

**Other Sources of Information**
- Draft discussion material from previous Property/Casualty codification projects, Chapter 5.
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Statutory Issue Paper No. 3
Accounting Changes

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting and GAAP differ in accounting for corrections of errors and certain changes in accounting. Statutory accounting and GAAP are similar in their treatment of mergers and changes in reporting entities. The purpose of this issue paper is to codify statutory guidance and to expand disclosure requirements for changes in accounting, which include changes in accounting principle, estimate, and reporting entity, and for correction of an error in previously issued financial statements in order to achieve the concept of consistency/comparability as defined in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. The term accounting change means a change in an accounting principle, an accounting estimate or the reporting entity. The correction of an error in previously issued financial statements is not deemed to be an accounting change.

Accounting Principle

3. A change in accounting principle results from the adoption of an accepted accounting principle different from the one previously used for reporting purposes. An accounting principle includes not only accounting principles and practices but also the methods of applying them.

4. A characteristic of a change in accounting principle is that it concerns a choice from among two or more accounting principles. However, neither (a) initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or that previously were immaterial in their effect nor (b) adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring is a change in accounting principle.

Accounting Estimate

5. Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements which require estimating the effects of future events. Examples of items for which estimates are necessary include service lives of depreciable assets and uncollectible receivables. Accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

Correction of an Error

6. Errors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles or oversight or misuse of facts that existed at the time the financial statements were prepared. In contrast, a change in accounting estimate results from new information or subsequent developments and accordingly from better insight or improved judgment. Thus an error is distinguished from a change in estimate.
7. Current statutory treatment shall be retained as follows:

- Changes in accounting principles and corrections of errors in previously reported financial statements shall be reported as adjustments to surplus in the period of the change in accounting principle or the period an error is detected.
- A change in the method of applying an accounting principle shall be considered as a change in accounting principle for purposes of applying the accounting principles set forth in this paper.
- A change in accounting estimate shall be included in the statement of income in the period when the change becomes known.

8. If the effect of a change in accounting principle is inseparable from the effect of a change in accounting estimate, then the change shall be considered as a change in accounting estimate for purposes of applying the accounting principles set forth in this paper. The treatment of a change resulting from an insurance department examination will depend on whether the change resulted from a correction of an error, a change in accounting principle or a change in estimate.

9. Material changes which do not affect assets, liabilities, revenues, expenses or surplus but which do affect historical information in the financial statement supplemental schedules (e.g., Schedule P) shall be reflected in the current years’ schedules with appropriate notations made directly to the affected schedules and in the notes to the financial statement.

10. For mergers, restatement of prior years’ amounts in the Annual Statement shall be required. Additionally, restatement shall be required for the two most recent years’ included in the Five Year Historical Summary. The Five Year Historical Summary shall include a footnote that the other three years have not been restated. A company that merges with an entity which effectively is a shell company (i.e., the other entity has no outstanding underwriting liabilities), shall be exempt from the above requirements.

Disclosures

11. Disclosure of material changes in accounting and correction of errors shall include:

- a brief description of the change, encompassing a general disclosure of the reason and justification for change or correction.
- the impact of the change or correction on net income, surplus, total assets and total liabilities for the two years presented in the financial statements (i.e., the balance sheet and statement of income and operations).
- the effect on net income of the current period shall be disclosed for a change in estimate that affects several future periods, such as a change in the service lives of depreciable assets or actuarial assumptions affecting pension costs. Disclosure of the effect on those income statement amounts is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts; however, disclosure is recommended if the effect of a change in the estimate is material.

DISCUSSION

12. Accounting Principles Board Opinion No. 9, Reporting the Results of Operations (APB 9) and Accounting Principles Board Opinion No. 20, Accounting Changes (APB 20) address GAAP accounting and reporting for accounting changes. Portions of these pronouncements are not applicable to statutory accounting and some of the guidance is not consistent with statutory objectives. Therefore, rejection of APB 20 in its entirety and the portions of APB 9 that address the treatment of extraordinary items and prior period adjustments is recommended.

13. The consistency concept within the Statement of Concepts is concerned with the regulator’s need for meaningful, comparable financial information to determine an entity’s financial condition through
consistency in the development and application of statutory accounting principles. In keeping with the Statement of Concepts, comparability of financial information would be best served by the restatement of prior year financial information for certain changes in accounting principle as well as the correction of an error in the previous year. However, existing statutory accounting guidance and practice requires such an item to be shown as an adjustment to surplus. In order to bridge the gap between current statutory accounting guidance and the achievement of comparability sought by the Statement of Concepts, additional disclosure as to the general description and the effect of such changes on income and surplus for all periods presented would provide the financial statement reader enough information to understand the effect of such change on consistency between periods.

14. The modification of existing statutory accounting for additional disclosure relating to changes between years and correction of prior errors bridges the gap between GAAP accounting as required by APB 20 and APB 9. More importantly, the added disclosure bridges the gap between current statutory procedures and the concept of consistency/comparability required by the Statement of Concepts.

Drafting Notes/Comments
- Accounting for Consolidations of Majority-owned Subsidiaries is addressed in a separate issue paper (see Issue Paper No. 1).
- Accounting for mergers is addressed in a separate issue paper. This may include an expansion of the traditional definition of a merger to include all combinations or assumptions which, in substance, are mergers.
- Extraordinary items are discussed in a separate issue paper.
- Specific discussion regarding reserve changes including a change in valuation basis is addressed in a separate paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
15. Statutory accounting is specific as to the treatment of accounting changes. The primary statutory accounting guidance is the NAIC Annual Statement Instructions (Annual Statement Instructions). Summarized, the Annual Statement Instructions specify that a change in accounting principle or the correction of an error is to be reported as an adjustment to surplus. Changes in accounting estimates are to be included in the statement of income for the current period. The treatment for a merger requires that prior year’s amounts be restated and reported on a merged basis consistent with the current year’s post-merger reporting basis.

16. The issues of changes in accounting principles and estimates are not specifically addressed in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies.

17. Chapter 10 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, in a discussion on recoveries from salvage and subrogation, states that:

Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of this change should be reported as a write-in item in the surplus section of the annual statement. The change in the reserve calculated using the net method should be included in net income for the year of the change and all future years.

18. The Annual Statement Instructions (which documents the conclusions reached by the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force in meeting 92-1) addresses accounting changes. The instructions state that:
Amounts reported in prior years may need to be adjusted in the current year as a result of the following:

Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.

Changes in accounting estimates as a result of new events or new information.

Corrections of errors in previously filed information.

A merger.

If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these Instructions or the NAIC Accounting Practices and Procedures manual specifically provide for a different treatment:

1. The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus. The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

2. The effects of changes in accounting estimates are included in income and expenses in the Statement of Income for the current year. For example, a change in the estimate of loss reserves for losses related to prior years should be included in the Statement of Income in losses incurred for the current year.

3. The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus.

4. In the case of a merger, prior years’ amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year’s post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

If one of the above described adjustments is required that does not affect assets, liabilities, revenues or expenses but which does adjust historical information, such as that found in Schedule P, the change may be made in the currently filed annual statements; however, appropriate notations of such adjustments should be made directly on the schedules affected and in the notes to the Financial Statements.
Generally Accepted Accounting Principles

19. Statutory accounting treatment is similar to GAAP except for the following:

- when reporting changes in accounting principles, GAAP accounting requires that the cumulative effect of a change be reported in the statement of income as a separate line item. Statutory accounting requires this to be shown as a separate component of surplus.
- GAAP accounting requires that corrections of errors be reported as prior period adjustments with adjustment to the prior year income and surplus.
- accounting for changes in a reporting entity includes several circumstances in which there may be a change in reporting entity. The only relevant area as it applies to Statutory Accounting is that of a merger. As such, this is the only area which Statutory Accounting specifically addresses.

20. The primary GAAP accounting guidance with respect to accounting changes comes from APB 20, paragraph 19, which states that changes in accounting principles are to be reported as follows:

   a. Financial statements for prior periods included for comparative purposes should be presented as previously reported.
   b. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of the period of the change.
   c. The effect of adopting the new accounting principle on income before extraordinary items and on net income of the period of the change should be disclosed.
   d. Income before extraordinary items and net income computed on a pro forma basis should be shown on the face of the income statements for all periods presented as if the newly adopted accounting principle had been applied during all periods affected.

21. APB 20 also states that changes in accounting estimates are to be accounted for as follows:

   ...the effect of a change in accounting estimate should be accounted for in
   a. the period of change if the change affects that period only or
   b. the period of change and future periods if the change affects both.

   A change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

22. For changes in the reporting entity (e.g., a merger), APB 20 states the following:

   ...accounting changes which result in financial statements that are in effect the statements of a different reporting entity should be reported by restating the financial statements of all prior periods presented in order to show financial information for the new reporting entity for all periods.

23. For changes in accounting principles inseparable from changes in accounting estimates, APB 20 states:

   Changes of this type are often related to the continuing process of obtaining additional information and revising estimates and are therefore considered as changes in estimates for purposes of applying this Opinion.

24. Lastly, according to APB 20, corrections of errors are to be accounted for as follows:

   Correction of an error in the financial statements of a prior period discovered subsequent to their issuance should be reported as a prior period adjustment.
25. GAAP accounting provides guidance with respect to the accounting for prior period adjustments in APB 9, paragraph 18. APB 9 states that “When comparative statements are presented corresponding adjustments should be made of the amounts of net income (and the components thereof) and retained earnings balances (as well as of other affected balances) for all of the periods reported therein, to reflect the retroactive application of the prior period adjustments.” Additionally, APB 9 requires footnote disclosures regarding such changes.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, Losses
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Minutes, 92-1, 91-4
- NAIC Annual Statement Instructions

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 9, Reporting the Results of Operations
- Accounting Principles Board Opinion No. 20, Accounting Changes
- FASB Statement No. 16, Prior Period Adjustments

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Draft discussion materials from previous Property/Casualty codification projects, Prior Period Adjustments/Corrections of Errors
Statutory Issue Paper No. 4
Definition of Assets and Nonadmitted Assets

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. One of the cornerstones of the statutory accounting model is the use of nonadmitted assets. This concept interjects a level of conservatism in the reporting of an insurance enterprise’s statutory financial position and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Currently, statutory accounting does not address the general definition of assets as used in the statutory accounting model. Furthermore, statutory accounting is not explicit and is sometimes inconsistent with regard to the guidelines for accounting for nonadmitted assets. Current guidance allows the establishment of an asset. This asset is charged against surplus as a nonadmitted asset, and is also depreciated or amortized against net income as its estimated economic benefit expires. Current guidance also allows in limited circumstances for a nonadmitted asset to be charged through operations when acquired.

The purpose of this issue paper is to provide a definition of an “asset” for use in statutory accounting and establish consistent treatment of nonadmitted assets.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted. The criteria used is outlined in paragraph number 3 below.

1 FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6), states:

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...

3. As stated in the Statement of Concepts, “The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet”, and are, therefore, considered nonadmitted. For purposes of the Codification, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting and is one which is:
a. Specifically identified within the Codification as a nonadmitted asset or
b. Not specifically identified within the Codification as an admitted asset.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

4. Transactions which do not give rise to assets as defined in paragraph 2 shall be charged to operations in the period the transactions occur. Those transactions which result in amounts which may meet the definition of an asset, but are specifically identified within the Codification as not giving rise to assets (e.g., policy acquisition cost), shall also be charged to operations in the period the transactions occur.

DISCUSSION

5. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies define the term nonadmitted asset as an asset that has been “accorded limited or no value in statutory reporting.” Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies further elaborates by saying, “Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets.” Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes a similar discussion.

6. The concept of nonadmitted assets can be traced back to the 1874 Association Blank, thus establishing general acceptance through universal use. Statutory accounting does not specifically address the general definition of an asset. CON 6, which was adopted as part of the framework to be utilized in the Codification, does provide a general definition of assets. This provides an appropriate measure for statutory assets.

7. The adoption of the above accounting principles will be consistent with the recognition concept within the Statement of Concepts (i.e., the ability to meet policyholder obligations as predicated on the existence of readily marketable assets available when both current and future obligations are due).

Drafting Notes/Comments
- Accounting Practices and Procedures manual states that non-admittance of accrued investment income is to be recorded as a reduction of investment income. This is specifically addressed in a separate issue paper.
- Deferred premiums is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. Statutory accounting in this area is general and somewhat inconsistent. The prefaces to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies state:

State statutes and accompanying regulations generally define what may be included as assets on a balance sheet, i.e., admitted assets. Because of the conservatism intrinsic to insurance accounting, certain assets may be accorded limited or no value in statutory reporting, i.e., nonadmitted assets. The investments a company is permitted to make and the limitations and
methods of valuation for inclusion as admitted assets are usually specified. Also, because of the nature of the calculation of certain liabilities, offsetting of assets is permitted in order to maintain consistency. The discussion of assets in Part One includes certain nonadmitted as well as admitted assets.

9. Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses the accounting for periodic transactions for nonadmitted assets as follows:

Some assets or portions thereof may be nonadmitted because they do not conform to the laws and regulations of the various states. As a result, certain assets which normally would be accorded value in noninsurance corporations are accorded no value and thus reduce the reported surplus of the insurance company. In addition, state regulations require that certain expenditures which could normally be capitalized by a non-insurance company be charged as an expense.

Changes between years in nonadmitted assets are usually charged directly to surplus. The change between years in nonadmitted investment income due or accrued, though, is reported as a component of investment income in the summary of operations.

Even though a state insurance code may prohibit or limit certain assets, these assets are generally carried in the company’s general ledger. Depreciable assets are depreciated in a systematic and rational manner over their estimated useful lives.

10. Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies states:

Because, in many respects, the statutory balance sheet is presented on a conservative basis, certain assets (which may have a recognized value in noninsurance corporations) are accorded no value and thus reduce the reported surplus of the insurance company. Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets. Changes in the amount of nonadmitted assets are charged or credited directly to surplus.

Each chapter in this book relating to investments discusses the limitations in amount and quality of investments that are treated as admitted. In general, authorized investments that are within the limitations of the laws and regulations of the various states are considered to be admitted assets. Investments exceeding the limitations, or those of questionable quality, may be nonadmitted.

11. Chapter 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies also provides some general guidance on certain nonadmitted assets. A sample follows:

Electronic Data Processing Equipment: Application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software’s expected useful life.

Equipment, Furniture and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.
Generally Accepted Accounting Principles
12. Asset recognition is governed by FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6), paragraphs 25 - 34. An asset is defined in paragraph 25 of CON 6 as follows:

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

13. Paragraph 26 of CON 6, further defines the characteristics of an asset as follows:

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, pg. v and Chapter 9
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, pg. v and Chapter 9

Generally Accepted Accounting Principles
- FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Draft discussion material from previous Property/Casualty codification projects
- Draft discussion material from previous Life codification projects
Statutory Issue Paper No. 5
Definition of Liabilities, Loss Contingencies and Impairments of Assets

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently does not define the term liability for use in preparation of statutory financial statements. Statutory accounting does address the accounting for certain liabilities within the statutory framework. The current statutory accounting guidance results in some confusion about when the recording of a liability, loss contingency or impairment of an asset is required outside the specific guidance prescribed by statutory accounting. The purpose of this issue paper is to provide a definition of a “liability” for statutory accounting purposes and to provide the accounting principles to be followed when recording such a liability in statutory financial statements. This paper also establishes the criteria for recording loss contingencies and impairments of assets.

SUMMARY CONCLUSION

Liabilities

2. For purposes of statutory accounting, a “liability” shall be defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes but is not limited to liabilities arising from policyholder obligations (e.g. policyholders benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a Company’s financial statements when incurred.

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[1] FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6), states:

Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...

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3. Estimates (e.g., loss reserves) are required in financial statements for many ongoing and recurring activities of a reporting entity. The mere fact that an estimate is involved does not of itself constitute a loss contingency. For example, estimates of losses utilizing appropriate actuarial methodologies meet the definition of liabilities as outlined above and are not loss contingencies.
Loss Contingencies or Impairments of Assets

4. For purposes of implementing the statutory accounting principles of loss contingency or impairment of an asset described below the following additional definitions shall apply:

- **Probable** - The future event or events are likely to occur.

- **Reasonably Possible** - The chance of the future event or events occurring is more than remote but less than probable.

- **Remote** - The chance of the future event or events occurring is slight.

5. A “loss contingency” or “impairment of an asset” is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future event(s) occur or fail to occur (e.g., collection of receivables).

6. An estimated loss from a loss contingency or the impairment of an asset shall be recorded by a charge to operations if both of the following conditions are met:

   a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability, and

   b. The amount of loss can be reasonably estimated.

7. This accounting shall be followed even though the application of other prescribed statutory accounting principles or valuation criteria may not require, or does not address, the recording of a particular liability or impairment of an asset (e.g., known impairment of an invested asset even though published VOS manual has not recognized impairment).

8. Additionally, in instances where a judgment, assessment or fine has been rendered against a company, there is a presumption that the criteria in paragraph 6 a. and 6 b. have been met. The amount of the liability shall include the anticipated settlement amount, legal costs, insurance recoveries and other related amounts and shall take into account factors such as the nature of the litigation, progress of the case, opinions of legal counsel, and management’s intended response to the litigation, claim, or assessment.

9. When condition 6 a. above is met with respect to a particular loss contingency, and the reasonable estimate of the loss is a range, which meets condition 6 b. above, an amount shall be accrued for the loss. When an amount within management’s estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the midpoint (mean) in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be used.

Disclosure

10. If a loss contingency or impairment of an asset is not recorded because only one of the conditions 6 a. or 6 b. is met, or if exposure to a loss exists in excess of the amount accrued pursuant to the provisions described above, disclosure of the loss contingency or impairment of the asset shall be made in the notes to the financial statements when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.
11. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

12. Certain loss contingencies, the common characteristic of each being a guarantee, shall be disclosed in financial statements even though the possibility of loss may be remote. Examples include (a) guarantees of indebtedness of others, and (b) guarantees to repurchase receivables (or, in some cases, to repurchase related properties) that have been sold or otherwise assigned. The disclosure of those loss contingencies, and others that in substance have the same characteristics, shall be applied to statutory financial statements. The disclosure shall include the nature and amount of the guarantee. Consideration shall be given to disclosing, if estimable, the value of any recovery that could be expected to result, such as from the guarantor’s right to proceed against an outside party.

**DISCUSSION**


14. Although the above accounting principles are not specifically discussed in current statutory accounting literature, these principles are well established in the determination of policy reserves in the life insurance and property and casualty accounting models. Both models use actuarial methods to establish the accounting estimates recorded. Obligations incurred in the normal conduct of business (e.g., obligations to pay employees, obligations to pay for assets or services acquired, etc.) represent other examples of applying the accounting principles described above.

15. Consistent with the solvency and conservatism concepts in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy, the statutory accounting model uses numerous accounting methods to accomplish the objective of reporting a company’s statutory financial position to demonstrate solvency. These accounting methods (nonadmitted assets, Asset Valuation Reserves, etc.) normally do not meet the criteria required in applying the accounting principles described in the Conclusion above. Therefore, such accounting methods should be applied by direct charges to or appropriation of a Company’s surplus. Notwithstanding the application of these statutory accounting methods, when an event, situation, transaction or other information comes to the financial statement preparer’s attention that indicates a liability or loss has been incurred or that an asset has been impaired, the accounting principles described in the Conclusion above should be followed.

16. Paragraph 9 provides guidance on recording an estimate which lies within an estimated range. It is anticipated that using the midpoint in a range will be applicable only in the rare instance where there is a continuous range of possible values, and no amount within that range is any more probable than any other. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine their best estimate of the liability.
17. Disclosure of the nature of accruals made in applying the above statutory accounting principle and in some circumstances the amount accrued may be necessary for the fair presentation of the statutory financial statements.

Drafting Notes/Comments
- Appropriation of retained earnings and gain contingencies (e.g., paragraphs 15 and 17 of FAS 5) are covered in separate issue papers.
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, is addressed in its entirety in a separate issue paper.
- Impairment of mortgage loans, real estate investments and other invested assets are addressed in separate issue papers.
- Policy, loss and claim reserves are addressed in separate issue papers.
- Surplus notes is addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
18. As discussed above, current statutory accounting is limited to dealing with specific asset and liability captions included on a company’s statement of financial position.

Generally Accepted Accounting Principles
19. Relevant sections of GAAP literature follow:

FASB Statement of Concepts No. 6 - Elements of Financial Statements
35. Liabilities are probable future sacrifices of economic benefits arising from obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

21 Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster’s New World Dictionary, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

22 Obligations in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (Webster’s New World Dictionary, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).

36. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. Liabilities commonly have other features that help identify them - for example, most liabilities require the obligated entity to pay cash to one or more identified other entities and are legally enforceable. However, those features are not essential characteristics of liabilities. Their absence, by itself, is not sufficient to preclude an item’s qualifying as a liability. That is, liabilities may not require an entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity before the time of settlement. Similarly, although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if for other reasons the entity has the
duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity.

**FASB Statement No. 5 - Loss Contingencies**

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a “gain contingency”) or loss\(^1\) (hereinafter a “loss contingency”) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

\(^1\) The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

2. Not all uncertainties inherent in the accounting process give rise to contingencies as that term is used in this Statement. Estimates are required in financial statements for many on-going and recurring activities of an enterprise. The mere fact that an estimate is involved does not of itself constitute the type of uncertainty referred to in the definition in paragraph 1. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the period of use by an enterprise does not make depreciation a contingency; the eventual expiration of the utility of the asset is not uncertain. Thus, depreciation of assets is not a contingency as defined in paragraph 1, nor are such matters as recurring repairs, maintenance, and overhauls, which interrelate with depreciation. Also, amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

   a. **Probable.** The future event or events are likely to occur.

   b. **Reasonably possible.** The chance of the future event or events occurring is more than remote but less than likely.

   c. **Remote.** The chance of the future event or events occurring is slight.

**Accrual of Loss Contingencies**

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income\(^3\) if both of the following conditions are met:

   a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.\(^4\) It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

\(^3\) Paragraphs 23-24 of APB Opinion No. 9, “Reporting the Results of Operations,” describe the “rare” circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

\(^4\) Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.
Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual\(^5\) made pursuant to the provisions of paragraph 8, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading.

10. If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.\(^6\) The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. Disclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable.

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\(^5\) Terminology used shall be descriptive of the nature of the accrual (see paragraphs 57-64 of Accounting Terminology Bulletin No. 1, “Review and Resume”).

\(^6\) For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 8(a) but that is not accrued because the amount of loss cannot be reasonably estimated (paragraph 8(b)). Disclosure is also required of some loss contingencies that do not meet the condition in paragraph 8(a) - namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

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FASB Interpretation No. 14 - Reasonable Estimation of the Amount of Loss, An Interpretation of FASB Statement No. 5

3. When condition (a) in paragraph 8 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.\(^1\) In addition, paragraph 9 of the Statement may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 10 requires disclosure of the nature of the contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

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\(^1\) Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.
RELEVANT LITERATURE

Statutory Accounting Practices and Procedures
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles
- FASB Statement of Accounting Concepts No. 6, *Elements of Financial Statements*
- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss, An Interpretation of FASB Statement No. 5*
- FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5*
- Accounting Principles Board Opinion No. 12, *Omnibus Opinion—1967, paragraphs 2 and 3*

State Regulations
- Oregon Insurance Statutes, Title 56, Chapter 733, *Accounting and Investments*
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Statutory Issue Paper No. 6
Amounts Due From Agents and Brokers

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Some reporting entities conduct a significant amount of their business through insurance agents and brokers. For purposes of this issue paper the term agent will be used as reference to both entities. In the ordinary course of business, amounts may be due from or payable to agents by a reporting entity. Business reasons for these transactions vary between each type of entity transacting business with the reporting entity. These variations may be the result of formal contractual requirements, the nature of the insurance products being sold or the services being performed. Statutory accounting for amounts due from agents is not addressed in sufficient detail in either the Accounting Practices and Procedures Manuals for Life and Accident and Health or for Property and Casualty Insurance Companies. Additionally, interpretation and application of accounting practices dealing with amounts due from agents are inconsistent among states. This issue paper establishes a framework for the accounting and reporting of amounts due from agents and brokers (collectively referred to as “agents”) that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Amounts due from agents can result from various insurance transactions ranging from premiums collected on behalf of the reporting entity to amounts advanced to the agent by the reporting entity to finance agency operations. Premiums owed by the agent shall be reflected net of commissions, if permitted by the contract. In almost all cases these transactions result in an amount due to the reporting entity that meets the definition of an asset as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. First, an evaluation shall be made to determine nonadmitted amounts. Next, an evaluation shall be made of such assets in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

   a. The uncollected agent's receivable which is over ninety days due shall be accounted for as a nonadmitted asset regardless of any offsetting amount (e.g., unearned premium).

   b. Remaining amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable the agent’s receivable is uncollectible, any uncollectible agent's receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

3. Advances to agents - All such balances, which are primarily encountered in the life insurance industry, are nonadmitted if a) the amounts are in the form of unsecured loans or advances, or b) the contractual terms for repayment are through application of future renewal commissions and/or other credits, or c) the terms of repayment do not provide readily available cash for the satisfaction of policyholder liabilities.
4. The following situations provide additional guidance in determining the nonadmitted portion of agent’s balances as discussed above:

a. Amounts payable to agents under the same contractual agreement - If amounts are both payable to and receivable from an agent, and the contractual agreements between the agent and the reporting entity permit offsetting, then the nonadmitted portion of amounts due from that agent should be calculated on the net balance due.

b. Amounts due from agents (affiliated or nonaffiliated) paid prior to the date of the financial statements and repaid to the agent by the reporting entity or one of the reporting entity's affiliates subsequent to the date of the financial statements - Such amounts should be accounted for in accordance with the substance of the transaction (a “wash” transaction) and not its form. Accordingly, the amounts due should be reestablished as an asset and subjected to asset collectibility and nonadmitted asset calculations using the original due date of the receivable. Short-term financing by third parties should also be considered “wash” transactions if the substance of the transaction is to avoid the nonadmitted asset principle set forth above.

c. Amounts classified as nonadmitted assets collected subsequent to date of the statutory financial statements - Such amounts shall not be used to adjust the nonadmitted asset otherwise calculated.

d. Determination of the Due Date -

i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.

ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.

iii. The due date for audit premiums and retrospective premiums is governed by policy or contract provisions. If the due date for receivables relating to these policies is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.

iv. These provisions are to be applied to all balances due except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For forced placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 4.d.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

e. Reconciling items between a Reporting Entity’s Account and Agent’s Account - If such amounts are over ninety days due, the amounts shall be nonadmitted.
DISCUSSION

5. The Statement of Concepts states:

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

6. Based upon the above concept, agents’ balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to operations. The adoption of a write-off/allowance methodology will provide a more appropriate measure of those assets available to meet policyholder obligations.

7. Under the conservatism concept of statutory accounting, premiums and other amounts collected by the agents on behalf of the reporting entity, which are over 90 days due and advances made to an agent, should be treated as nonadmitted assets and charged to surplus. In keeping with the concept of conservatism, subsequent collection of nonadmitted assets should not be considered in the determining period-end nonadmitted assets. These recoveries should be accounted for in the period received.

8. The draft discussion materials from previous Property/Casualty codification projects suggested aging of all original or renewal premiums receivable to begin as of the effective date of the policy regardless of whether the reporting entity is using a direct bill or account current system. In addition, the proposed version requires endorsement premiums and installment premiums to begin aging from the effective date of the endorsement and from the due date of the installment. An exception is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the lending institution, and premium is booked by the reporting entity at the notice of default date. There is, typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium is remitted to the reporting entity from the proceeds of the foreclosed property this grace period results in a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2 is the date at which the grace period expires.

9. Current statutory accounting for life and accident and health companies generally requires agents’ balances to be nonadmitted. This is not consistent with the treatment of such balances for property and casualty companies. The majority of agents’ balances for life and accident and health companies consist of advances to agents under agents’ contracts. This paper does not recommend a change for these types of balances. Advances to agents under agents’ contracts would follow the treatment outlined in the Summary Conclusion above. To the extent the agents’ balance consists of amounts other than advances to agents under agents’ contracts, the recommended treatment outlined in this paper is theoretically different from existing practice. Adoption of the principles outlined in the Summary Conclusion above for life and accident and health and property and casualty companies will provide necessary consistency without having a significant impact on the conservatism of the statutory financial statements.
**Drafting Notes/Comments**

- This issue paper does not address nonadmitted assets for retrospective premiums on direct or assumed business as this issue was addressed and codified by the NAIC in 1993. Current guidance is included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies. This is addressed in a separate issue paper.
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently reported on the same line in the Annual Statement, are addressed in a separate issue paper.
- In preparing this paper, the following issues were identified as future potential issue paper topics:
  - Right of Offset - (agent commissions, reinsurance premiums payable and receivable, etc.)
  - Aging/nonadmitting of reinsurance premiums due (governed by Chapter 22)
  - Premiums sold with recourse (premium finance company)
  - Accounting/aging of retrospective premiums currently reported on line 9.2 or line 9.3 is addressed in a separate issue paper.
  - Accounting for uncollected premium balances is addressed in Issue Paper No. 10 - Uncollected Premium Balances.
  - Accounting for bills receivable is addressed in Issue Paper No. 21 - Bills Receivable for Premiums.
  - Sale of premium receivables will be addressed in Issue Paper No. 42 - Sale of Premium Receivables.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:**

**Statutory Accounting**

10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 7, *Agents’ Balances or Uncollected Premiums*, page 2, paragraph 2, provides the following guidance:

   To satisfy the requirements of the annual statement blank, agents’ balances or uncollected premiums over three months due are nonadmitted assets. (See Chapter 9 - Nonadmitted Assets, see excerpt below.)

11. Chapter 9, *Nonadmitted Assets*, page 1, point 3, reinforces Chapter 7 by stating the following:

   Agents’ Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents’ balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection.

12. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies is silent with respect to when the aging of agents’ balances and uncollected premiums is to commence, however, the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) reached a consensus in the 89-2 session which states the following:

   **Aging of Agents’ Balances**

   The issues considered were:

   1. In computing the non-admitted portion of agents’ balances, should an agents’ account current be aged from the dates of the account current statement or from the effective dates of the individual policies billed in the statements?

      The consensus of the group was that accounts current should be aged from the dates of the statements.
2. How should balances be aged when the account current system is not used?

   The balance should be aged from the effective date of the policy.

13. Chapter 9 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses the nonadmitting of certain assets as follows:

   Some examples of assets which are nonadmitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or other reasons are:

   1. deposits in suspended depositories;
   2. agents' debit balances;
   3. bills receivable which are not properly secured by collateral;
   4. loans on personal security (endorsed or not) which are not properly secured by collateral;
   5. cash advanced to or in the hands of officers or agents;
   6. travel advances.

**Generally Accepted Accounting Principles**

14. GAAP accounting for agent balances or uncollectible premiums/receivables is governed by FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

   1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

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   1The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

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   3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

      a) Probable. The future event or events are likely to occur.
      b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
      c) Remote. The chance of the future event or events occurring is slight.

   8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met:

      a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
b) The amount of loss can be reasonably estimated.

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3 Paragraphs 23-24 of APB Opinion No. 9, “Reporting the Results of Operations,” describe the “rare” circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this statement.

4 Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

15. The FAS 5 criteria above, is used in interpreting information such as historical trending and general information about the stability of the agents\insured in an effort to evaluate the adequacy of a premium receivable allowance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

16. GAAP accounting requires the aging of agents’ balances or uncollected premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement’s effective date and installment premiums should begin from the installment’s due date. Although not specifically stated, this guidance can be deduced through review of FASB Statement of Financial Accounting Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 83, as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable.\(^{50}\) Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

b. Earned. Revenues are not recognized until earned. An entity’s revenue earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,\(^{51}\) and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no “earning process,” and for recognizing gains, being earned is generally less significant than being realized or realizable.

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\(^{50}\) The terms realized and realizable are used in the Boards conceptual framework in precise scenes, focusing on conversion or convertibility of noncash assets into cash or claims to cash (Concepts Statement 3, par. 83). Realized has sometimes been used in a different, broader sense: for example, some have used that term to include realizable or to include certain conversions of noncash assets into other assets that are also not cash or claims to cash. APB Statement 4, paragraphs 148-153, used the term realization even more broadly as a synonym for recognition.
“Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being ‘earned’ gradually and continuously by the whole of enterprise activities. Earning in this sense is a technical term that refers to the activities that give rise to the revenue-purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the earning process” (APB Statement 4, par. 149). Concepts Statement 3, paragraph 64, footnote 31, contains the same concept.

17. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the agents’ balance or uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the due date of the installment.

18. Although the realization characteristic of revenue recognition may have been triggered, the more important characteristic of earned may not have been, hence, the recording of an unearned premium.

19. FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date as this is the date when revenue recognition begins.

OTHER SOURCES OF INFORMATION

20. The draft discussion materials from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents’ balances and uncollected premiums. The following represents a summary of those modifications:

When the original or deposit premium are more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies of bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

21. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, this version discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

22. The draft discussion materials from previous Property/Casualty codification projects contradicted the Emerging Accounting Issues Working Group’s consensus by proposing the following:

Original or deposit premiums
Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.

Endorsement
Aging is always based on the effective dates of the endorsements.
Installs
Aging is always based on the due date of the installment.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises

State Regulations
- State regulations contain numerous references to amounts due from agents and brokers. Due to the volume, specific references to each state regulation has not been reproduced in this issue paper.

Other Sources of Information
- Draft discussion materials from previous Property/Casualty codification projects
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 9
Statutory Issue Paper No. 7
Asset Valuation Reserve and Interest Maintenance Reserve

STATUS
Finalized March 16, 1998

Type of Issue:
Life and Accident and Health Insurance Companies

SUMMARY OF ISSUE

1. Current statutory accounting guidance requires life and accident and health insurance companies to recognize liabilities for an asset valuation reserve (AVR) and an interest maintenance reserve (IMR). There is no such requirement for property and casualty insurance companies. The AVR is intended to establish a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

2. The purpose of this issue paper is to establish statutory accounting principles for AVR and IMR that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. The IMR and AVR shall be calculated and reported in accordance with Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC (Purposes and Procedures Manual of the SVO).

DISCUSSION

4. This issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

5. This issue paper rejects paragraph 28 (subtitled, Reporting of Realized Investment Gains and Losses of Investments) of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97), as amended by FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), for Life and Accident and Health Insurance Companies.

6. As stated in the draft discussion material from previous Life Codification projects, Chapter 16B, Asset Valuation Reserve, “The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.”
7. Chapter 16 A Interest Maintenance Reserve, in the draft discussion material from previous Life Codification projects states, “The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold.” These reserves serve to stabilize statutory surplus against fluctuations in the market value of securities and provide an extra layer of protection for policyholders. Furthermore, gains trading (i.e., selectively selling securities to include realized gains in earnings) opportunities are reduced by reporting an IMR. This is consistent with the Conservatism concept included in the Statement of Concepts, which states, “valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.”

8. The accounting policy to record AVR and IMR also is consistent with the “ultimate objective of solvency regulations” as stated in the Statement of Concepts. This states, “the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.”

9. Because AVR and IMR only pertain to life and accident and health insurance companies, there is a difference in how Life and Accident and Health Insurance Companies and how Property and Casualty Insurance Companies account for investments. Property and Casualty Insurance Companies are required to record bonds and preferred stock with a NAIC designation of 3 through 6 at the lower of amortized cost or market. This provides a conservative measure of such securities in accordance with the conservatism concept in the Statement of Concepts.

Drafting Notes/Comments
- Realized gains and losses for insurers not maintaining an IMR are addressed in specific invested asset issue papers.
- This issue paper references the Purposes and Procedures Manual of the SVO. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 7 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
10. Chapter 16, Asset Valuation Reserve and Interest Maintenance Reserve, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners.

11. Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC contains the following excerpts (note that this is not quoted in its entirety):

This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC’s Life and Health Annual Statement Instructions published July 28, 1994 for specific accounting and reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:
The Default Component--

(i) The Bond and Preferred Stock Subcomponent
(ii) The Mortgage Subcomponent

The Equity Component--

(i) The Common Stock Subcomponent
(ii) The Real Estate and Other Invested Assets Subcomponent

(A) Interest Maintenance Reserve (IMR). This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

The current year’s IMR is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes
plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes
less an amortization amount

(a) Interest Related Realized Capital Gains and Losses:

The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.

A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security’s beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991, the debt security’s rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security’s gain or loss should not be included in this reserve if the debt security rating was ever a “6” during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of “PSF-4”, “PSF-5”, “PSF-6” or “P-4”, “P-5” or “P-6” at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock’s beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a
negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Capital gains or (losses) due to interest rate changes on fixed income investments with less than one year to expected maturity should be captured in the IMR. Gains or (losses), net of capital gains tax, in the remaining categories are amortized according to the Group Amortization Schedule Section 6(B)(j) or the seriatim method.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company’s assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments.

(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company's general account liabilities (Page 3, Line 26),

2. the transaction is irrevocable and is to a non-affiliate and

3. the transaction was completed in the current year.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.

2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.

3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The
associated assets are not necessarily the same as the assets transferred as part of the transaction.

2) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in the same manner as capital gains and losses on fixed income investments. A gain or loss is considered material if it is in excess of both .01% of liabilities and $1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule:

1. Seriatim Method— The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the seriatim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over par value.

The seriatim calculation on an asset by asset basis is the desired approach, but since a seriatim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. Grouped Method— A company may use a standard “simplified method” by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

a. less than 1 calendar year to expected maturity
b. 1 to 5 calendar years to expected maturity
c. 6 to 10 calendar years to expected maturity
d. 11 to 15 calendar years to expected maturity
e. 16 to 20 calendar years to expected maturity
f. 21 to 25 calendar years to expected maturity
g. over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or "yield to worst"). Potential retirement dates include all possible call dates, and the contractual maturity date. When the instrument’s contractual terms include scheduled sinking fund payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

“Calendar years to expected maturity” means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.

- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

- For the year ending December 31, 1994, only loan-backed and structured securities that meet the following definition are required to be valued using currently anticipated prepayments:

  Loan-backed and structured securities that have potential for loss of a significant portion of the original investment due to changes in interest rates or the prepayment rate of the underlying loans supporting the security. These securities should include, but are not limited to, interest-only structured securities and structured securities purchased at a significant premium over pay value.
For residential mortgages and residential mortgage pass-throughs other than Real Estate Mortgage Investment Conduits (REMICs), not valued using currently anticipated prepayments, the number of calendar years to expected maturity is defined to be one half of the number of calendar years to final maturity.

For REMICs and other asset backed investments not valued using currently anticipated prepayments, purchased at the time of original issuance, the calendar year of expected maturity is the calendar year of issue plus the weighted average life (rounded to the nearest whole number) as stated in the Offering Circular, using the prepayment assumption stated in the Circular to be used for Federal Income Taxation.

For REMICs and other asset-backed investments not valued using currently anticipated prepayments, purchased after the original issuance, it is permissible for the Company to re-compute the weighted average life of the investment based on the same prepayment assumptions used to compute the purchase price, provided that this re-computation is done in a consistent manner for all similar asset-backed investments.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.

The following information is presented to assist in determining the proper accounting:

<table>
<thead>
<tr>
<th>General Account IMR Balance</th>
<th>Separate Accounting IMR Balance</th>
<th>Net IMR Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>Positive</td>
<td>Positive (See rule a)</td>
</tr>
<tr>
<td>Negative</td>
<td>Negative</td>
<td>Negative (See rule b)</td>
</tr>
<tr>
<td>Positive</td>
<td>Negative</td>
<td>Positive (See rule c)</td>
</tr>
<tr>
<td>Positive</td>
<td>Negative</td>
<td>Negative (See rule d)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Positive (See rule e)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Negative (See rule f)</td>
</tr>
</tbody>
</table>

Rules:

a) If both balances are positive, then report each as a liability in its respective statement.
b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.

c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.

d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.

e) If the general account balance is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.

f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) Asset Valuation Reserve (AVR). This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:

The Default Component

The Bond and Preferred Stock Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D, Part 1 and Part 2--Section 1 and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB, Part E, Section 1.

The Mortgage Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

(a) Calculation of the AVR:

The current year’s AVR by subcomponent is equal to:
The beginning balance
plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent
plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent
plus (minus) transfers between components
plus an annual contribution
plus any voluntary contribution
plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security’s beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a “6” during the holding period.

Preferred stock that had an NAIC/SVO rating classification of “PSF-4”, “PSF-5”, “PSF-6”, “P-4”, “P-5” or “P-6” at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.
(c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on derivative instruments not accounted for as hedging transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments.

(d) Transfers Between Components:

If the sum of a subcomponent’s beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent’s maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.

If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its “sister” subcomponent within the same component is positive, the negative amount should be transferred to the “sister” sub-component to the extent that the transfer does not reduce the positive balance before transfers of the “sister” sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval.

(e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The amortization rate times the subcomponent maximum amount minus the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement).

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

12. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, Corporate and Finance, which states:
(4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

(12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

Generally Accepted Accounting Principles
13. AVR and IMR are not addressed in current GAAP literature.

14. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

Reporting of Realized Investment Gains and Losses of Investments

28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

OTHER SOURCES OF INFORMATION
15. The draft discussion material from previous Life Codification projects contains the following excerpts:

Chapter 16A - Interest Maintenance Reserve

All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.

The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and mortgages.
Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Purposes and Procedures of the Securities Valuation Office of the NAIC, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 16, Asset Valuation Reserve and Interest Maintenance Reserve

Generally Accepted Accounting Principles
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities

State Regulations
- Texas Administration Code, Title 28 - Insurance, Chapter 7, Corporate and Finance

Other Sources of Information
- Draft discussion material from previous Life Codification projects, Chapter 16A, Interest Maintenance Reserve, and Chapter 16B, Asset Valuation Reserve
Statutory Issue Paper No. 8
Accounting for Pensions

STATUS
Finalized December 6, 1999

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies do not address employers accounting for pension plans. However, a position paper was prepared by the Study Group of EX4 on Accounting for Insurance Company-Funded Pensions and was adopted by the NAIC. The adopted position does not mandate a specific accounting method but calls for expanded disclosures with regard to pension accounting and is documented in the September 15, 1987 Accounting Practices and Procedures (EX4) Task Force minutes. Under this existing guidance, reporting entities have the option of continuing to recognize pension costs on the pay-as-you-go (Employee Retirement Income Security Act funding) method or adopting the provisions of FASB Statement No. 87, Employers’ Accounting for Pensions (FAS 87), which requires recognition of pension costs over the period a participant renders service to the reporting entity and recognition of a liability for unfunded costs.

2. FAS 87 requires recognition of pension costs over the period a participant renders service to the reporting entity and recognition of a liability for unfunded costs. It also permits the recognition of an asset when the pension plan is over funded (i.e., plan assets exceed plan liabilities). FASB Statement No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88), requires recognition of previously unrecognized amounts when a reporting entity settles or curtails a defined benefit plan or provides benefits in connection with the termination of an employee. FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (FAS 132), specifies disclosure requirements for pension and other postretirement benefit plans.

3. The purpose of this issue paper is to establish statutory accounting principles for an employer's pension obligations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Defined Benefit Plans

4. A defined benefit plan defines the amount of the pension benefit that will be provided to the plan participant at retirement or termination. For such benefit plans, reporting entities shall adopt FAS 87 with a modification to exclude non-vested employees. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan are recognized as a component of the net periodic pension cost in the period the employee becomes vested. Any intangible asset or prepaid expense resulting from adoption of the provisions of this issue paper shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations. This is consistent with the definition of assets and nonadmitted assets set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets.

5. If a reporting entity settles or curtails a defined benefit plan, the reporting entity shall immediately recognize all previously unrecognized amounts as discussed below. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation.
by eliminating the risks relative to the obligation and the assets associated with the plan (e.g., making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits or purchasing nonparticipating annuity contracts to cover vested benefits). If a settlement occurs and the net result is a loss, such loss is recognized at the time of the settlement. If the net result is a gain, such gain is not recognized until the proceeds are received by the reporting entity. A curtailment is an event which significantly alters the make up of the pension plan (e.g., a reduction in the years of service required or the employees covered). If a curtailment occurs, there are generally two components to any gain or loss. Any unrecognized prior service cost shall be recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, such loss shall be recognized when it is probable that the curtailment will occur and that the effects can be reasonably estimated. If the net result is a gain, such gain shall not be recognized in earnings until the employees terminate or the plan suspension or amendment is adopted and the proceeds are received by the reporting entity. When such gains are recognized, any excess tax surcharges shall also be recognized.

**Defined Contribution Plans**

6. A defined contribution plan defines the amount of the employer's contributions to the plan and its allocation to plan participants. The pension benefit provided to the plan participant at retirement or termination depends on the amount of employer and employee contributions, earnings on plan investments and, in some plans, other participant forfeitures.

7. For defined contribution plans, the reporting entity shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses, and shall be nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants beginning at the date the participant initially vests in plan contributions.

8. Certain defined contribution plans may define the employer's contribution as a percentage of the plan participants' individual compensation rather than as a specific dollar amount which is allocated among the plan participants. If an employer's contributions to a defined contribution plan are in excess of those required under the plan and required to be allocated to individual participants, such amounts are recorded as a prepaid expense and nonadmitted under statutory accounting principles.

**Disclosures**

9. The disclosures required by paragraph 5 of FAS 132 shall be included in the notes to the statutory financial statements considering the modification in this issue paper to include only vested employees. Paragraph 5 of FAS 132 is included in the Relevant GAAP Guidance section of this issue paper.

10. The disclosures required by paragraph 5 of FAS 132 shall be made when an employer recognizes a gain or loss related to a settlement or curtailment of a defined benefit plan or when providing termination benefits.

**Transition**

11. At the effective date of Codification, the transition obligation or asset shall be determined as the difference between the vested projected benefit obligation and the fair value of plan assets. If prior to the effective date of Codification, the reporting entity has adopted FAS 87 for statutory accounting purposes, the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.
12. At the effective date of Codification, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;
b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

13. At the effective date of Codification, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;
b. Alternatively, the reporting entity may elect to accrue the incremental asset as a component of net periodic pension cost in an amount each period such that total net periodic pension cost may be reduced to an amount not less than zero (i.e., the accrual of the incremental asset may be used to offset current period net periodic pension cost).

An incremental asset resulting from a transition obligation that is less than an amount previously recorded under FAS 87 should first reduce the recorded liability. Any remaining incremental asset shall be recorded as nonadmitted.

**Consolidated/Holding Company Plans**

14. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 4 to 13 of this issue paper shall be applied.

**DISCUSSION**

15. The conclusions in paragraphs 4 to 13 above adopt FAS 87, FAS 88, and FAS 132 with the following modifications:

a. Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts.
b. Any asset which results from an excess of the fair value of plan assets over the pension obligation shall be recorded as a nonadmitted asset.
c. At the date of adoption of this accounting principle, the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods.
d. A net gain (net of excess tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity.
e. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132.

f. Disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for income on a statutory basis.

This is consistent with the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

16. This issue paper also adopts FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan, FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan, FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits, and FASB Emerging Issues Task Force No 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination.

17. Accounting for any intangible asset or prepaid expense resulting from application of the provisions of this issue paper as a nonadmitted asset is consistent with the recognition concept in the Statement of Concepts which states that:

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

18. The transition rules have been modified from FAS 87. For an incremental asset or liability which is not recorded immediately upon adoption of the above provisions, an employer is permitted to amortize the incremental asset or liability as a component of net periodic pension cost over future periods in accordance with paragraphs 12 and 13. FAS 87 requires that any transition amount be amortized on a straight-line basis over the average remaining service period of employees expected to receive benefits (except for employers with all or nearly all inactive employees or those with an average remaining service period of less than 15 years).

19. The guidance as discussed in paragraph 1 above, requires expanded disclosures rather than mandating a specific accounting method. However, this adopted position is inconsistent with the concept of recognition outlined in the Statutory Statement of Concepts which states: “Liabilities require recognition as they are incurred.” Therefore, adoption of FAS 87, with modifications, will be required for statutory accounting and reporting.

Drafting Notes/Comments
- Postemployment benefits are addressed in Issue Paper No. 13 – Employers’ Accounting for Postemployment Benefits.
- Postretirement benefits other than pensions are addressed in Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions.
- Other deferred compensation plans, such as Rabbi Trusts and ESOPs, are addressed in a separate issue paper.
- The tax attributes associated with the accounting principles discussed in this paper (i.e., deferred income taxes) are not currently recognized in existing statutory accounting guidance. Accounting principles for federal income taxes are addressed in a separate issue paper.
- Holding company obligations are addressed in a separate issue paper.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
20. The position adopted by the Accounting Practices and Procedures (EX4) Task Force is summarized in the minutes from its September 15, 1987 meeting. Key points are paraphrased below:

For multi-company plans sponsored by a parent company, the pension expenses would be the amount contributed by the company to the parent company related to the pension plan. This is comparable to the treatment of multi-employer and similar plans under FAS 87.

For plans sponsored by the reporting company, pension expense is the amount to be funded for the period. If the company chooses to adopt FAS 87 and 88, any resulting intangible or prepaid asset would be considered nonadmitted unless approved by the insurer's state of domicile as appropriate. For self-funded plans, i.e. where the company reflects the assets of the pension plan among its own assets, the amount of accrued pension costs and its location in the balance sheet should be disclosed. Accrued pension costs related to the pension plan would be determined in accordance with accepted actuarial methods.

For companies which report on a GAAP basis, but choose to retain statutory accounting methods for state regulatory reporting, additional footnote disclosures supplementing those outlined below are encouraged but not required.

21. The following observations, among others, were made by the Study Group of EX4:

One of the principal reasons that FAS 87 and 88 were adopted under GAAP was to improve income statement comparability. This comparability has a stronger emphasis on a GAAP income statement than is typical for statutory reporting which is balance sheet oriented.

The liquidation priority of a pension plan liability appears to be behind policyholder liabilities. It appears that unless there is a perfected interest by the pension plan participants or the Pension Benefit Guaranty Corp., that the pension plan stands as a general creditor behind the policyholder. The FASB is less interested in this aspect since the thrust of its position was one of economic over legal substance. However, statutory accounting is on a modified going-concern basis. In addition, the interest of the policyholder is of utmost importance and is primarily responsible for the rationale used in statutory reporting. Nevertheless, the responsibility of the insurance company to live up to its pension plan obligations on an ongoing basis must be recognized.

If FAS 87 were adopted for SAP, certain issues would need to be addressed such as whether the assets (prepaid pension cost and an intangible asset) and liabilities (accrued pension cost) that may arise should be permitted or required to be reported in the financial statements. It would appear that the prepaid and intangible assets would be considered nonadmitted assets since they represent assets, potential or otherwise, not available to satisfy policyholder obligations. Furthermore, companies with unfunded pension plans could be impaired or rendered insolvent by implementing GAAP basis accounting for pensions.

22. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies specify the required disclosures developed by the Study Group of EX4 and adopted by EX4 which include:

a. a description of the plan's funding policy,
b. the method of determination and the amount of pension expense,
c. the amount of the accumulated benefit obligation, the amount of vested benefits and the fair value of the plan assets valued as of the most recent actuarial valuation date,
d. any funding waiver requested or obtained from the IRS,
e. for an unfunded plan, the method of funding the obligation and how the deficiency will be met,
f. significant matters affecting the year-to-year comparability of the pension information and

g. the location(s) and amount(s) of liabilities for benefits.

Illustrations of sample disclosures are also provided in the Annual Statement Instructions.

23. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, contains the following with respect to pension plans:

Liabilities for Benefits for Employees and Agents

A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include: 1. It may be desirable to hold the liability for a nonqualified pension plan in this category in order to assist the tax department in adjusting their tax deductions.

Generally Accepted Accounting Principles

24. FAS 87 focuses primarily on single-employer defined benefit plans and requires:

a. a standardized method for measuring net periodic pension cost (unit credit actuarial method or projected unit credit actuarial method depending on the type of plan),

b. immediate recognition of a liability (the minimum liability) when the accumulated benefit obligation exceeds the fair value of plan assets with delayed recognition of the offsetting amount as an increase in net periodic pension cost, and

c. various disclosures about the plan including the components of net pension cost and of the projected benefit obligation in the financial statements. (Paraphrased from the “Fundamentals of Pension Accounting” section of the “Summary” section immediately preceding the FAS 87 statement.)

25. The following is a brief paraphrased summary of the key provisions under FAS 87:

FAS 87 requires the recognition of a liability (unfunded accrued pension cost) if net periodic pension cost as determined under FAS 87 exceeds amounts the employer has contributed to the plan. An asset (prepaid pension cost) is recognized if net periodic pension cost is less than amounts the employer has contributed to the plan.

For defined benefit pension plans, an additional pension liability (referred to as the minimum liability) must be recognized when the accumulated benefit obligation (defined in FAS 87) for plan participants exceeds the fair value of the plan assets plus or minus any accrued or prepaid pension expense. If an additional liability is recognized, an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (defined in FAS 87). If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) is reported as a reduction in equity, net of any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of FASB Statement No. 109, Accounting for Income Taxes.

The intangible asset representing the unrecognized prior service cost (which at the date of initial adoption would be the unrecognized net obligation) is amortized as a component of the net periodic pension cost on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan, except that, (a) if the average remaining service period is less than 15 years, the employer may elect to use a 15-year period, and (b) if all or almost all of a plan's participants are inactive, the employer shall use the inactive participants' average remaining life expectancy period.
26. FAS 88 prescribes a method for determining the amount to be recognized in earnings when a pension obligation is settled, a plan is curtailed or benefits are provided to employees in connection with their termination of employment. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan. A curtailment is an event which significantly alters the makeup of the pension plan (e.g., a reduction in the years of service required or the employees covered).

27. FAS 88 requires recognition of certain previously unrecognized amounts when certain transactions or events occur, the source and timing of the amount to be recognized in earnings will vary with the nature of the transaction. Generally, if a settlement occurs, a gain or loss is recognized related to previously unrecognized gains or losses from either changes in assumptions or actual results which were different from that assumed. In addition, any unamortized net asset from the implementation of FAS 87 is recognized as a gain. If a curtailment occurs, there are generally two components to any gain or loss. Any unrecognized prior service cost is recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or a loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, it is recognized when it is probable that the curtailment will occur and that the effects are reasonably estimable. If the net result is a gain, it is not recognized in earnings until the employees terminate or the plan suspension or amendment is adopted.

28. FAS 132 requires the following disclosures:

Disclosures about Pensions and Other Postretirement Benefits

5. An employer that sponsors one or more defined benefit pension plans or one or more defined benefit postretirement plans shall provide the following information:

a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes, contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements

c. The funded status of the plans, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:

(1) The amount of any unamortized prior service cost

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2 For defined benefit pension plans, the benefit obligation is the projected benefit obligation—the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. For defined benefit postretirement plans, the benefit obligation is the accumulated postretirement benefit obligation—the actuarial present value of benefits attributed to employee service rendered to a particular date.

3 The effects of foreign currency exchange rate changes that are to be disclosed are those applicable to plans of a foreign operation whose functional currency is not the reporting currency pursuant to FASB Statement No. 52, Foreign Currency Translation.

4 Refer to footnote 3.
(2) The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)
(3) The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of Statement 87 or 106
(4) The net pension or other postretirement benefit prepaid assets or accrued liabilities
(5) Any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended
d. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized transition obligation or transition asset, the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment
e. The amount included within other comprehensive income for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
f. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
g. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved
h. The effect of a one-percentage-point increase and the effect of a one-percentage point decrease in the assumed health care cost trend rates on (1) the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost and (2) the accumulated postretirement benefit obligation for health care benefits (For purposes of this disclosure, all other assumptions shall be held constant, and the effects shall be measured based on the substantive plan that is the basis for the accounting.)
i. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period
j. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of Statement 87 or paragraphs 53 and 60 of Statement 106
k. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation
l. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event
m. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Statement.

Amounts related to the employer’s results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the employer’s statement of financial position shall be disclosed for each balance sheet presented.

Employers with Two or More Plans

6. The disclosures required by this Statement may be aggregated for all of an employer’s defined benefit pension plans and may be aggregated for all of an employer’s defined benefit postretirement plans or may be disaggregated in groups if that is considered to provide the most useful information or is otherwise required by paragraph 7. Disclosures about pension plans with assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for postretirement plans. However, if those disclosures are combined, an employer shall disclose the aggregate benefit obligation and aggregate fair value of
plan assets for plans with benefit obligations in excess of plan assets. The aggregate pension accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets also shall be disclosed. Disclosure of amounts recognized in the statement of financial position shall present prepaid benefit costs and accrued benefit liabilities separately.

7. An employer may combine disclosures about pension or postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Reduced Disclosure Requirements for Nonpublic Entities

8. A nonpublic entity\(^5\) may elect to disclose the following for its pension and other postretirement benefit plans in lieu of the disclosures required by paragraph 5 of this Statement:

\(^5\) A nonpublic entity is any entity other than one (a) whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b).

a. The benefit obligation, fair value of plan assets, and funded status of the plan
b. Employer contributions, participant contributions, and benefits paid
c. The amounts recognized in the statement of financial position, including the net pension and other postretirement benefit prepaid assets or accrued liabilities and any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended
d. The amount of net periodic benefit cost recognized and the amount included within other comprehensive income arising from a change in the minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
e. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
f. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved
g. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period
h. The nature and effect of significant nonroutine events, such as amendments, combinations, divestitures, curtailments, and settlements.

Defined Contribution Plans

9. An employer shall disclose the amount of cost recognized for defined contribution pension or other postretirement benefit plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.
Multiemployer Plans

10. An employer shall disclose the amount of contributions to multiemployer plans during the period. An employer may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

11. Paragraph 70 of Statement 87 and paragraph 83 of Statement 106 are carried forward without reconsideration. Paragraphs 70 and 83 read as follows:

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of FASB Statement No. 5, Accounting for Contingencies, shall apply.

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of FASB Statement No. 5, Accounting for Contingencies.

OTHER SOURCES OF INFORMATION

29. The NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 23, General Expenses and Taxes, Licenses and Fees, contains the following language:

Pension Costs

Many insurance companies offer their employees pension plans as part of the compensation package for service rendered. Pension plans include defined contribution or defined benefit pension plans. The accounting for each of these types differs.

For defined benefit pension plans, an insurance company is responsible for providing a specified benefit to the plan participants at retirement. The insurance company has the option of recognizing the benefit costs by adoption Financial Accounting Standards Board Statement of Financial Accounting Standard (FAS) No. 87, "Employers' Accounting for Pensions," or based upon funding required under the Employee Retirement Income Security Act (ERISA).

If FAS 87 is adopted, pension service costs must be recognized over the period a participant renders service to the company for qualified and non-qualified (e.g. Top Hat Plans) defined benefit pension plans.

If the ERISA funding method is elected, an insurance company will record the pension service costs for defined benefit pension plans based upon requirements of ERISA for qualified pension plans. Pension service costs will then be recorded in conjunction with funding required by ERISA for such qualified plans on a pay-as-you-go basis. When ERISA dictates additional funding is required, the employer will recognize this funding as a corresponding expense.

If the ERISA funding method is elected for qualified defined benefit pension plans, pension service costs associated with any non-qualified plans must be accrued as earned. Those service
costs must be accrued over the working lives of the participants covered under the non-qualified plan.

For defined contribution benefit plans, the insurance company is responsible for making specific contributions to a participant's pension plan account. The insurance company must accrue the contributions required by the plan in the period in which those contributions are earned. Contributions to plan participants' accounts required during the participants' working lives must be expensed over that period. The contributions required after participants terminate or retire require an expense be accrued and a liability established over the working lives of the participants.

If a company makes contributions to the defined contribution plan in excess of those allocated to individual participants, the excess is recorded as a prepaid asset.

Settlements and Curtailments of Pension Plans

Companies that offer their employees defined benefit pension plans periodically settle or curtail the plan.

A settlement is a transaction which is irrevocable, releases the employer from responsibility for the pension, and eliminates the risks relative to the obligation and the assets associated with the plan. For example, lump-sum cash payout to the employees in lieu of their pension rights.

A curtailment is an event which significantly alters the make up of the pension plan. For example, the years of service required is reduced or the employees covered under the plan is decreased.

Settlements and curtailments of pension plans should be accounted for using generally accepted accounting principles.

30. The chapter on Non-Claim Operating Expenses included in the draft discussion material from previous Property/Casualty codification projects contains the following language which contradicts some of the Life Codification language:

Statement of the Financial Accounting Standards Board (“FASB”) No. 87, “Employers' Accounting for Pensions” was issued in December 1985 and superseded Accounting Principles Board (“APB”) Opinion 8 “Accounting for the Cost of Pension Plans”. FASB 87 should be followed in accounting for pension plans. FASB 87 requires that pension plans be accounted for on the accrual basis of accounting and any difference between “Net Period Pension Cost” incurred and the amount actually funded is accrued. GAAP permits the recognition of an asset for the excess of any pension funds over the plan's liabilities. SAP, however, does not permit the recognition of any prepaid pension expense. “Net Periodic Pension Cost” includes the following components:

1. Current service cost. (The present value of future benefits earned for the employee's current service.)

2. Amortization of unrecognized prior service or retroactive benefit costs over the future service periods of those employees active at the inception or plan amendment date. (The present value of future benefits credited for an employee's prior service at the inception or amendment of the plan should be ratably accrued over his remaining service life.)

3. “Gains and losses are changes in the amount of either the projected benefit obligation or plan assets resulting from experience different from that assumed and changes in assumptions.” “Because gains and losses may reflect refinements in estimates as well as real changes in economic values and because some gains in one period may be offset by losses in another or vice versa, ...” such gains and losses are not recognized as part of “net pension cost in the period in which they arise”. FASB 87 sets forth the minimum and alternative methods of amortizing net gains and losses.
FASB 88 “Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits” should be followed when such plans are terminated.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Minutes from the June 23, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 15, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the June 12, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 8, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Employers’ Accounting for Postretirement Benefits Other Than Pensions - Field Test of the Statutory Proposal - prepared by the Codification Advisory Group, September 20, 1992

Generally Accepted Accounting Principles
- FASB Statement No. 87, Employers’ Accounting for Pensions
- FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
- FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits
- FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan
- FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan
- FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits
- FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, General Expenses and Taxes, Licenses and Fees
- Draft discussion material from previous Property/Casualty codification projects - Chapter on Non-Claim Operating Expenses
Statutory Issue Paper No. 9
Subsequent Events

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies do not address the accounting treatment for events occurring subsequent to the period covered by statutory financial statements but prior to their issuance. Although general guidance for disclosing material subsequent events is found in the NAIC Annual Statement Instructions (Annual Statement Instructions) and guidance for identifying and disclosing material subsequent events is found in the NAIC Financial Condition Examiners Handbook, specific criteria as to whether a material subsequent event should be recorded in the current financial statements or simply disclosed in the notes to the financial statements is not defined. The purpose of this issue paper is to define “subsequent events” for statutory accounting purposes and to establish the criteria for recording such events in the financial statements and/or disclosing them in the notes to the financial statements.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, “subsequent events” shall be defined as events or transactions that occur subsequent to the balance sheet date, but prior to the issuance of the statutory financial statements. For purposes of this paper, the issuance of the statutory financial statements includes not only the submission of the Quarterly and Annual Statement but also the issuance of the audit opinion by the reporting entity’s certified public accountant.

3. Material subsequent events shall be considered either:
   a. Type I. Events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements.
   b. Type II. Events that provide evidence with respect to conditions that did not exist at the balance sheet date but arose subsequent to that date.

4. All information that becomes available prior to the issuance of the financial statements relating to a material Type I subsequent event shall be used by management to determine a related accounting estimate (see Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets). Any changes in estimates resulting from the use of such evidence shall be recorded in the financial statements unless specifically prohibited (e.g., subsequent collection of agents balances over 90 days due when determining nonadmitted agents balances as prohibited by Issue Paper No. 6 - Amounts Due from Agents and Brokers). For material Type I subsequent events, the nature and the amount of the adjustment shall be disclosed in the notes to the financial statements only if necessary to keep the financial statements from being misleading.

5. Information that becomes available prior to the issuance of the financial statements relating to a material Type II subsequent event shall not be recorded in the financial statements, but shall be disclosed in the notes to the financial statements. If an event is of such a nature that pro forma disclosures are

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necessary to keep the financial statements from being misleading, disclosure of supplemental pro forma financial data shall be made including the impact on net income, surplus, total assets and total liabilities giving effect to the event as if it had occurred on the date of the balance sheet.

6. The conclusions in this issue paper, including the disclosures in paragraph 5, shall also apply to quarterly statement filings.

DISCUSSION

7. The above conclusion expands and clarifies the guidance provided in the NAIC Financial Condition Examiners Handbook and the Annual Statement Instructions by requiring that Type I subsequent events be recorded in the financial statements.

8. The Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) states that “the cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders.” The recording of Type I subsequent events provides the regulator relevant information to evaluate the financial condition of an entity. However, in some circumstances, the recording of Type I subsequent events is specifically prohibited within Codification (e.g., subsequent collection of agent’s balances over 90 days due when determining nonadmitted agents balances).

9. Identifying events that require adjustment of the financial statements under the criteria stated in the conclusion calls for the management of the entity to exercise judgment and accumulate knowledge of the facts and circumstances surrounding the event. For example, a loss on an uncollectible agent’s balance as a result of an agent’s deteriorating financial condition leading to bankruptcy subsequent to the balance sheet date would be indicative of conditions existing at the balance sheet date, thereby requiring the recording of such event to the financial statements before their issuance. On the other hand, a similar loss resulting from an agent’s major casualty loss such as a fire or flood subsequent to the balance sheet date would not be indicative of conditions existing at the balance sheet date and recording of the event to the financial statements would not be appropriate. However, this is a Type II subsequent event which would require disclosure in the notes to the financial statements as described in paragraph 5 above.

10. Additionally, the Statement of Concepts states that “Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity’s short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management’s discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.” Disclosure of Type II subsequent events meets this objective. Examples of Type II events that require disclosure to the financial statements (but should not result in adjustment) are: i) sale of a bond or capital stock issue, ii) purchase of a business, iii) settlement of litigation when the event giving rise to the claim took place subsequent to the balance sheet date and iv) casualty losses resulting from a hurricane or earthquake subsequent to the balance sheet date.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
11. The Annual Statement Instructions for Life and Accident and Health Insurance Companies require disclosure of subsequent events in the notes to the financial statements as follows:

Events Subsequent
Instruction:

Describe any events occurring subsequent to the close of the books or accounts for this statement which may have a material effect on the financial condition of the company.

Illustration:

On February 1, 19__, the Board of Directors adopted a plan for recapitalization subject to shareholder approval, which would effect an amendment to the Certificate of Incorporation to increase the authorized common shares from _________ to_____________.

12. The Annual Statement Instructions for Property and Casualty Insurance Companies is similar to the Life and Accident and Health instructions above.

13. Part 1, Section 5, Report on Full Scope Examination, of the NAIC Financial Condition Examiners Handbook discusses reporting of transactions consummated subsequent to the effective date of the examination as follows:

Any transaction consummated by a company subsequent to the effective date of an examination, which is for the purpose of adjusting the company’s previously reported financial condition, shall not be recognized in the preparation of the examiner's financial statement in the report of examination.

Such transaction may be described by a qualifying statement, or statements, when supported by a reference to the original minutes or document evidencing such subsequent transaction or transactions. Such supporting data shall be set forth in a clearly captioned appendix or appendices to the report.

14. Exhibit G to Part 1 (General) of the NAIC Financial Condition Examiners Handbook provides a list of procedures to assist in identifying subsequent events but does not provide guidance as to the treatment of the events once identified. A list of the procedures are as follows:

EXHIBIT G--
REVIEW OF EVENTS SUBSEQUENT TO THE BALANCE SHEET DATE

Company ___________ Examination Date ___________ Approved By ___________

Generally, the period of review of post-balance sheet events extends from the date of the balance sheet to the date of the examination report, which in most cases is the date of substantial completion of the fieldwork. It is usually not possible, however, to extend all procedures to the same date. If delivery of the examination report is unduly delayed, consideration should be given to extending the review to a later date.

The workpaper should contain specific information as to the scope of investigation of subsequent events and the consideration given to each of them. Procedures related to subsequent events that extend into the subsequent period include, but are not necessarily limited to, the items described below.

1. Scan cash receipts records for evidence of proceeds of loans, significant sales of productive assets or other unusual items.
   
   Amounts over $ ____________ Date through _______________

2. Scan cash disbursements records for unusual payments and payment of liabilities not recorded as of balance-sheet date.

   Amounts over $ ____________ Date through _______________
3. Review general journal entries for entries that would have a material effect upon the financial statement as of balance sheet date.

Amounts over $ ___________ Date through ______________

4. Read minutes of meetings to directors, stockholders and important committees up to the report date. If minutes have not been prepared, obtain a written representation from the secretary about matters dealt with at such meetings. Review draft (if any) or proxy statement to be issued to shareholders for matters that may affect the financial statements.

5. Read latest available interim financial statements. Compare them with the financial statements being reported on and obtain explanations for any unusual items noted as a result of the comparison.

Amounts over $ _____________ Date through ______________

6. Inquire of officers and other executives having responsibility for financial and accounting matters as to whether the interim statements have been prepared on the same basis as that used for the statements under examination. (Indicate identity of statements and periods covered.)

Amounts over $ ______________ Date through ______________

7. Inquire of officers and other executives having responsibility for financial and accounting matters (limited where appropriate to major locations) as to: (NOTE: Indicate persons with whom discussions were held and date and attach memoranda or comments regarding significant matters discussed. Corporate office inquiries should extend to the report date.)

a. Whether any substantial contingent liabilities or commitments existed at the balance-sheet date or at the date of inquiry.

b. Whether there was any significant change in the capital stock or debt to the date of inquiry.

c. The current status of items in the financial statements being reported on that were accounted for on the basis of tentative, preliminary, or inconclusive data.

d. Whether any other matters had occurred that would materially affect the financial statements or operations of the company. This includes appropriate inquiries as to subsequent events of material affiliates accounted for by the equity method.

Amounts over $ ______________ Date through ______________

8. If the above procedures produce responses that significantly affect the financial statements, they should be confirmed in writing. This may be done in the letter of representations.

Amounts over $ ______________ Date through ______________

**Generally Accepted Accounting Principles**

15. The primary source of GAAP authoritative guidance for the treatment of subsequent events is AICPA Statement on Auditing Standards No. 1, Section 560, *Subsequent Events*, which states the following:

.01 An independent auditor's report ordinarily is issued in connection with historical financial statements that purport to present financial position at a stated date and results of
operations and cash flows for a period ended on that date. However, events or transactions sometimes occur subsequent to the balance sheet date, but prior to the issuance of the financial statements and auditor’s report, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. These occurrences hereinafter are referred to as "subsequent events."

.02 Two types of subsequent events require consideration by management and evaluation by the independent auditor.

.03 The first type consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.

.04 Identifying events that require adjustment of the financial statements under the criteria stated above calls for the exercise of judgment and knowledge of the facts and circumstances. For example, a loss on an uncollectible trade account receivable as a result of a customer’s deteriorating financial condition leading to bankruptcy subsequent to the balance-sheet date would be indicative of conditions existing at the balance-sheet date, thereby calling for adjustment of the financial statements before their issuance. On the other hand, a similar loss resulting from a customer’s major casualty such as a fire or flood subsequent to the balance-sheet date would not be indicative of conditions existing at the balance-sheet date and adjustment of the financial statements would not be appropriate. The settlement of litigation for an amount different from the liability recorded in the accounts would require adjustment of the financial statements if the events, such as personal injury or patent infringement, that gave rise to the litigation had taken place prior to the balance-sheet date.

.05 The second type consists of those events that provide evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in adjustment of the financial statements.¹ Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. Occasionally such an event may be so significant that disclosure can best be made by supplementing the historical financial statements with pro forma financial data giving effect to the event as if it had occurred on the date of the balance sheet. It may be desirable to present pro forma statements, usually a balance sheet only, in columnar form on the face of the historical statements.

¹ This paragraph is not intended to preclude giving effect in the balance sheet, with appropriate disclosure, to stock dividends or stock splits or reverse splits consummated after the balance-sheet date but before issuance of the financial statements.

.06 Examples of events of the second type that require disclosure to the financial statements (but should not result in adjustment) are:

a. Sale of a bond or capital stock issue.

b. Purchase of a business.

c. Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.
d. Loss of plant or inventories as a result of fire or flood.

e. Losses on receivables resulting from conditions (such as a customer’s major casualty) arising subsequent to the balance-sheet date.

.07 Subsequent events affecting the realization of assets such as receivables and inventories or the settlement of estimated liabilities ordinarily will require adjustment of the financial statements (see paragraph .03) because such events typically represent the culmination of conditions that existed over a relatively long period of time. Subsequent events such as changes in the quoted market prices of securities ordinarily should not result in adjustment of the financial statements (see paragraph .05) because such changes typically reflect a concurrent evaluation of new conditions.

.08 When financial statements are reissued, for example, in reports filed with the Securities and Exchange Commission or other regulatory agencies, events that require disclosure in the reissued financial statements to keep them from being misleading may have occurred subsequent to the original issuance of the financial statements. Events occurring between the time of original issuance and reissuance of financial statements should not result in adjustment of the financial statements unless the adjustment meets the criteria for the correction of an error or the criteria for prior period adjustments set forth in Opinions of the Accounting Principles Board.* Similarly, financial statements reissued in comparative form with financial statements of subsequent periods should not be adjusted for events occurring subsequent to the original issuance unless the adjustment meets the criteria stated above.

2 However, see paragraph .05 as to the desirability of presenting pro forma financial statements to supplement the historical financial statements in certain circumstances.

* See also Statement of Financial Accounting Standards No. 16, Prior Period Adjustments (AC section A35).

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Financial Condition Examiners Handbook
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 6 - Amounts Due from Agents and Brokers

Generally Accepted Accounting Principles
- AICPA Statement on Auditing Standards No. 1, Section 560, Subsequent Events

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 10
Uncollected Premium Balances

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses direct and group billed uncollected premiums for Property and Casualty and Accident and Health policies. It does not address uncollected and deferred premiums for life considerations, which are addressed in a separate issue paper. The Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies (the Manuals) do not provide definitive guidance on when to begin aging premiums. This issue paper puts forth a framework for the accounting and reporting of uncollected premium balances that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Premium transactions result in amounts due to the reporting entity that meet the definition of an asset as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. First, an evaluation shall be made to determine nonadmitted amounts. Next an evaluation shall be made of the remaining admitted assets in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

   a. To the extent that there is no related unearned premium, any uncollected premium balances which are over ninety days due shall be accounted for as a nonadmitted asset. If an installment premium is over ninety days due, the amount over ninety days due plus all future installments that have been recorded on that policy shall be accounted for as nonadmitted assets.

   b. Amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable the uncollected premium balance is uncollectible, any uncollectible premiums receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

3. The following provides additional guidance in determining the nonadmitted portion of uncollected premiums:

   a. Amounts classified as nonadmitted assets collected subsequent to date of the statutory financial statements - Such amounts should not be used to adjust the nonadmitted asset otherwise calculated.
b. Determination of the Due Date -

i. The due date for original and deposit premiums is governed by the effective date of the underlying insurance contract and not the agent/reporting entity contractual relationship.

ii. The due date for endorsement and installment premiums is governed by the effective date of the endorsement and the contractual due date of the installment.

iii. The due date for audit premiums and retrospective premiums is governed by policy provisions or contract provisions. If the due date for receivables relating to audits is not addressed by policy provisions or contract provisions, any uncollected premium (either accrued or billed) is nonadmitted.

iv. These provisions are to be applied to all premium receivables except those arising from force placed insurance obtained by a lender for collateral protection, certain policies, known as a Trustee Sales Guarantees (TSGs), issued by title insurance companies to lenders on defaulted real estate loans and crop/hail policies. For force placed insurance, the due date for purposes of applying paragraph 2 shall be the date of billing. For TSG policies, the due date for purposes of applying paragraph 2 shall be at the expiration of the grace period given to the defaulted debtor, which is provided by statute. Crop/hail premiums are considered installment premiums in accordance with paragraph 3.b.ii. and accordingly, the due date for purposes of applying paragraph 2 shall be governed by the contractual due date of the installment.

DISCUSSION

4. The Statement of Concepts states:

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

5. Based upon the above concept, uncollected premium balances should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired, regardless of aging, should be charged to income in the period such determination is made. Short-term policies shall also be subject to this collectibility analysis. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations. Under the conservatism concept of statutory accounting, uncollected premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted and charged to surplus. Uncollected installment premiums over ninety days due, even if they are determined to be collectible, should be nonadmitted along with all future installments. Additionally, the conservatism concept of statutory accounting will not allow subsequent collection of amounts charged to surplus as nonadmitted assets to reduce the nonadmitted asset. These recoveries will be accounted for in the period received.

6. An exception to the due date guidance is provided for force placed insurance and for certain title insurance policies known as TSGs. Force placed insurance is a type of collateral protection insurance typically offered to financial institutions and other lenders that make loans secured by collateral. Coverage is obtained by the lender when the collateral securing a loan becomes uninsured by the borrower. Due to the nature of this specific type of insurance, most policies or certificates are not issued, and consequently not billed, until after the effective date of coverage. As a result, the due date for purposes of paragraph 2 is the date of billing. TSGs are title insurance policies issued to lending...
institutions during the foreclosure process on defaulted real estate loans. TSGs are requested by the
lending institution, and premium is booked by the reporting entity at the notice of default date. There is,
typically by law, a grace period given to the defaulted debtor to bring the loan current. Since the premium
is remitted to the reporting entity from the proceeds of the foreclosed property, this grace period results in
a lag period before the premium could be collected. As a result, the due date for purposes of paragraph 2
is the date at which the grace period expires.

Drafting Notes/Comments
- A separate issue paper addresses deferred and uncollected life and annuity premiums.
- A separate issue paper addresses nonadmitted assets for retrospective premiums on direct or
assumed business; this issue was addressed and codified by the NAIC in 1993. Guidance is
included in Chapter 22 of the Accounting Practices and Procedures Manual for Property and
Casualty Insurance Companies.
- A separate issue paper addresses premiums sold with recourse (premium finance company).
- Reinsurance premiums payable, reinsurance commissions receivable, etc., which are currently
reported on the same line item in the Annual Statement are addressed in a separate issue paper.
- Accounting for uncollected agents' balances is addressed in Issue Paper No. 6 - Amounts Due
From Agents and Brokers.
- Accounting for bills receivable is addressed in Issue Paper No. 21 - Bills Receivable For
Premiums.
- Accounting/aging of retrospective premiums currently reported on line 9.2 or 9.3 is addressed in
a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
7. The draft discussion material from previous Property/Casualty codification projects suggested
aging of all original or renewal premiums receivable to begin as of the effective date of the policy. In
addition, the proposed version suggests endorsement premiums begin aging from the effective date of the
endorsement and installment premiums begin aging from the contractual due date of the installment. This
presentation is consistent with GAAP and provides for a conservative aging process.

8. The Accounting Practices and Procedures Manual for Property and Casualty Insurance
Companies, Chapter 7, Agents’ Balances or Uncollected Premiums, page 2, paragraph 2, provides the
following guidance:

To satisfy the requirements of the annual statement blank, agents' balances or uncollected
premiums over three months due are nonadmitted assets. (See Chapter 9 – Nonadmitted Assets,
see excerpt below.)

Companies, Chapter 9, Nonadmitted Assets, page 1, point 3, reinforces Chapter 7 by stating the following:

Agents Balances or Uncollected Premiums Over Three Months Due: The statutes of most states
require that agents' balances or uncollected premiums over three months due be nonadmitted
because of the uncertainty of collection.

10. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies,
Exhibit 2 - Analysis of Nonadmitted Assets, Line 24.2 - Premiums, Agents’ Balances and Installments
Booked but Deferred and Not Yet Due, provides additional guidance for nonadmitting installment
premiums as follows:

This item should include all future installments on all policies for which one or more installments
are over three months past due.
11. The Accounting Practices and Procedures Manuals for Property and Casualty and for Life and Accident and Health Insurance Companies do not address when the aging of uncollected premiums is to commence; however, the draft discussion material from previous Property/Casualty codification projects suggested the following:

**Original or deposit premiums**

Aging is always based on the effective date of the policy or bond regardless of whether the insurer is using a direct billing system or an account current system.

**Endorsement**

Aging is always based on the effective dates of the endorsements.

**Installments**

Aging is always based on the due date of the installment.

12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18, pages 3 and 4, discusses uncollected premiums as follows:

**Accident and Health Policies**

Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.

On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.

Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition.

**Generally Accepted Accounting Principles**

13. GAAP accounting for uncollectible premiums/receivables is governed by FASB Statement No. 5, *Accounting for Contingencies* (FAS 5), paragraphs 1, 3 and 8:

1. For the purpose of this Statement, a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a “gain contingency”) or loss1 (hereinafter a “loss contingency”) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incidence of a liability.

2. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incidence of a liability can range from probable
to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a) Probable. The future event or events are likely to occur.

b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

c) Remote. The chance of the future event or events occurring is slight.

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income\(^3\) if both of the following conditions are met:

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.\(^4\) It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

\(^3\)Paragraphs 23-24 of APB Opinion No. 9, Reporting the Results of Operations, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

\(^4\)Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

14. The FAS 5 criteria above is used in interpreting information such as historical trending and general information about the stability of the insureds in an effort to evaluate the collectibility of the receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

15. GAAP accounting requires the aging of direct billed premiums to begin from the effective date of the policy. Aging for endorsement premiums should begin from the endorsement's effective date and installment premiums should begin from the installment's contractual due date. Although not specifically stated, this guidance can be deduced through review of FASB Statement of Concepts No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 83, as follows:

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
b. Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no “earning process,” and for recognizing gains, being earned is generally less significant than being realized or realizable.

16. The renewal or establishment of an insurance policy in exchange for a claim to cash (premium receivable) triggers the realization characteristic of revenue recognition, therefore, the aging of the uncollected premium should commence on the effective date of the new or renewed policy. Endorsement premiums will trigger the realization characteristic on the effective date of the endorsement, while installment premiums will trigger the realization characteristic on the contractual due date of the installment.

17. FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60), also provides some indirect guidance. FAS 60, paragraph 13, requires revenue on short-duration contracts to be recognized over the period of the contract in proportion to the amount of insurance protection provided. The contract period starts with the policy effective date. Therefore, it is reasonable to begin aging from the policy effective date, as this is the date when revenue recognition begins.

**OTHER SOURCES OF INFORMATION**

18. The draft discussion material from previous Property/Casualty codification projects proposed extensive modifications to the accounting for agents’ balances and uncollected premiums. The following represents a summary of those modifications:

When the original or deposit premium is more than ninety days past due based on an aging referenced to effective date and therefore, not admitted, all premiums subsequently charged on the same policies or bonds are similarly not admitted, except that if the amount of such original or deposit premiums does not exceed 20% of the subsequently charged premiums in the same policies or bonds, such subsequently charged premiums, if otherwise not themselves more than ninety days overdue, shall be allowed as admitted assets.

19. The same basic concept was also discussed for endorsement premiums and installment premiums. In addition, it discussed certain parameters where a greater than ninety day nonadmitted premium could be accounted for as an admitted asset. The modification was stated as follows:

A premium which has been determined to be not admitted may be treated as admitted if it has been collected within forty-five days of the date of determination and not more than ninety days had elapsed from the billing date to the date of determination and further, that not more than one hundred thirty-five days had elapsed from the effective date of the premium to the date of determination.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7 & 9
- NAIC Annual Statement Instructions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 18
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

**Generally Accepted Accounting Principles**
- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- Draft discussion material from previous Property/Casualty codification projects
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Statutory Issue Paper No. 11
Compensated Absences

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not specifically address the accounting for compensated absences (i.e., vested vacation benefits, vested sick pay benefits, and holidays) in either the Accounting Practices and Procedures manuals for Life and Accident and Health or for the Property and Casualty Insurance Companies. The purpose of this issue paper is to establish statutory accounting principles for compensated absences that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A reporting entity shall accrue a liability for employees’ compensation for future absences if all of the following conditions are met:
   a. The reporting entity’s obligation relating to employees’ rights to receive compensation for future absences is attributable to employees’ services already rendered,
   b. The obligation relates to rights that vest¹ or accumulate²,
   c. Payment of the compensation is probable, and
   d. The amount can be reasonably estimated.

3. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 2 only because the amount cannot be reasonably estimated (i.e., condition d. is not met), that fact and the reasons therefore shall be disclosed in a note to the financial statements. An employer is not required to accrue a liability for nonvesting accumulating rights for compensated absences as the right to receive these benefits is contingent upon future events and continued employment.

4. A reporting entity shall accrue a liability for employees’ compensated absences or, for services reimbursable under service agreements with an affiliate, if all of the above conditions are met.

5. Accounting changes adopted to conform to the provisions of this issue paper shall be accounted for in accordance with Issue Paper No. 3 - Accounting Changes. In the year the principle is adopted, recognition of the liability for compensated absences at the time of adoption that has not previously been recorded shall be recognized through a direct charge to surplus.
Consolidated/Holding Company Plans

6. The employees of many reporting entities are eligible for certain compensated absence benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for compensated absence benefits, then the requirements outlined above in paragraphs 2 - 5 shall be applied.

DISCUSSION

7. Paragraphs 2 - 5 of the Summary Conclusion above adopt FASB Statement No. 43, Accounting for Compensated Absences (FAS 43) with certain modifications to paragraphs 8 and 9. Paragraphs 8 and 9 discuss the effective date and the accounting for the retroactive adoption of FAS 43. This issue paper modifies these paragraphs by requiring the initial adoption of this accounting principle to be recorded as a change in accounting principle consistent with Issue Paper No. 3 (i.e., the cumulative effect of the change will be charged to surplus in the year of adoption).

8. Liability, as defined by Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets, is a probable future sacrifice of economic benefit arising from the present obligation of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transactions or events. Compensated absences, which meet the criteria discussed in the conclusion above, meet this definition of a liability. The recording of a liability for compensated absences is also consistent with presenting financial statements which support the Solvency and Conservatism concepts within the Statement of Concepts.

Drafting Notes/Comments

- Holding company obligations are addressed in a separate issue paper.
- Accounting for pensions is addressed in Issue Paper No. 8 - Accounting for Pensions.
- Employers’ accounting for postemployment benefits is addressed in Issue Paper No. 13 - Employers’ Accounting for Postemployment Benefits.
- Employers’ accounting for postretirement benefits other than pensions is addressed in Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Principles

9. Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, provides general guidance on the accrual of compensated absences as follows:

Liabilities for Benefits for Employees and Agents

A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include:

The company may wish to set up a liability for the salary for accrued but unused vacation hours since vacation hours can legitimately be viewed as “earned” at the end of the work periods for which they are granted.

**Generally Accepted Accounting Principles**

11. The accrual for compensated absences is governed by FAS 43, *Accounting for Compensated Absences*. Paragraphs 6, 7, 8 and 9 provide for the determination and treatment of compensated absences.

6. An employer shall accrue a liability for employees’ compensation for future absences if all of the following conditions are met:

   a. The employer’s obligation relating to employees’ rights to receive compensation for future absences is attributable to employees’ services already rendered,

   b. The obligation relates to rights that vest\(^1\) or accumulate\(^2\),

   c. Payment of the compensation is probable, and

   d. The amount can be reasonably estimated.

   If an employer meets conditions (a), (b), and (c) and does not accrue a liability because condition (d) is not met, that fact shall be disclosed.

7. Notwithstanding the conditions specified in paragraph 6, an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits\(^3\) (that is, compensation for an employee’s absence due to illness) for the reasons stated in paragraph 15.

\(^1\) In this Statement, vested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee’s future service.

\(^2\) For purposes of this Statement, accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.

\(^3\) In accounting for compensated absences, the form of an employer’s policy for compensated absences should not prevail over actual practices. For example, if employees are customarily paid “sick pay” benefits even though their absences from work are not actually the result of illness or if employees are routinely allowed to take compensated “terminal leave” for accumulated unused sick pay benefits prior to retirement, such benefits shall not be considered sick pay benefits for purposes of applying the provisions of paragraph 7 but rather should be accounted for in accordance with paragraph 6.

**Effective Date and Transition**

8. This Statement shall be effective for fiscal years beginning after December 15, 1980, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year restated.

9. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying the Statement shall be included in determining net
income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied. (See paragraph 20 of APB Opinion No. 20, Accounting Changes.) The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year’s net income shall be disclosed for that year.

OTHER SOURCES OF INFORMATION

12. Chapter 22 of the NAIC Technical Resource Group Proposed Draft Life Codification suggested the recording of a compensated absence liability under the following circumstances:

**Compensated Absences**

Employers pay their employees for absences due to vacations, sick time and holidays. Compensated absences must be accrued if all of the following criteria are met:

a. the employees have rendered services which obligate the employer to pay for future absences;

b. the employees are entitled to compensation even if employment is terminated;

c. payment of the compensation is probable; and

d. the amount can be reasonably estimated.

Salary advances to an employee can be used to reduce the liability for that employee’s compensated absences.

RELEVANT LITERATURE

**Statutory Accounting Practices and Procedures**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17

**Generally Accepted Accounting Principles**
- FASB Statement No. 43, *Accounting for Compensated Absences*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22
Statutory Issue Paper No. 12  
Accounting for Drafts Issued and Outstanding

STATUS  
Finalized March 16, 1998

Type of Issue:  
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting, as documented in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, provides guidance on the accounting for drafts but does not provide a definition of a draft. This issue paper will establish a definition for “draft” and will codify statutory accounting relating to drafts.

SUMMARY CONCLUSION

2. For purposes of statutory accounting, a “draft” is defined as an order to pay a sum certain in money, which is signed by the drawer (e.g., the insurance company or its agent), and payable to order or bearer (policyholder) by the drawee (bank) only upon approval by the insurance company once the draft has been presented to the drawee.

3. A reporting entity that utilizes instruments that meet the above definition of drafts shall elect one of the following accounting methods:

   a. **Draft Issued Method** - When a draft is issued, an increase in paid losses and a related decrease in loss reserves is recorded. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability.

   b. **Draft Honored Method** - An increase in paid losses and a related decrease in loss reserves is recorded when the draft is cashed and presented by the bank to the reporting entity for reimbursement. Consequently, under a draft honored method there is no liability for outstanding drafts.

The method elected by a reporting entity to account for drafts issued and outstanding shall remain consistent from year to year. Procedures for changes in the accounting method shall be governed by Issue Paper No. 3 - Accounting Changes.

DISCUSSION

4. Statutory accounting does not address the characteristics of a draft, however, Chapter 13, Other Liabilities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies does provide specific guidance on how to account for drafts. This guidance is consistent with GAAP accounting procedures for outstanding drafts as discussed in AICPA Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves.

5. Drafts and checks have different legal characteristics. A check is payable on demand, whereas a draft must be approved for payment by the issuer (the reporting entity) before it is honored by the bank. Because of these different characteristics, a draft meets the definition of a liability as defined by NAIC Issue No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. Outstanding checks are accounted for as a reduction of cash.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
6. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities, discusses the accounting for drafts as follows:

Companies may record loss and loss expense drafts written to claimants and policyholders on either a draft issued or a draft honored basis. On an issued system, paid losses and appropriate loss reserve releases are recorded when the draft is issued. Drafts that have not been presented for payment and remain outstanding at the balance sheet date are reflected as a liability under this caption.

Companies on a draft honored system do not record paid losses or release loss reserves until the drafts are cashed and presented by the bank to the company for reimbursement. Consequently, under a draft honored system there is no liability for outstanding drafts.

Generally Accepted Accounting Principles
7. AICPA Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves as incorporated through Appendix L of the AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, discusses the accounting for drafts as follows:

Drafts outstanding -- Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13

Generally Accepted Accounting Principles
- AICPA Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves
- AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies

State Regulations
- No additional guidance obtained from state statutes and regulations.
Statutory Issue Paper No. 13
Employers’ Accounting for Postemployment Benefits

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory practices and procedures do not address accounting for the estimated cost of benefits provided by an employer to former or inactive employees or agents after employment but before retirement (referred to as “postemployment benefits”). Postemployment benefits are all types of benefits provided to former or inactive employees or agents, their beneficiaries, and covered dependents. Those benefits include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers’ compensation), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage.

2. The purpose of this issue paper is to establish statutory accounting principles for postemployment benefits that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Employers shall accrue a liability for the reporting entity’s obligation to provide postemployment benefits if all of the following conditions are met:
   a. The obligation is attributable to employees’ or agents’ services already rendered,
   b. The obligation relates to rights that vest or accumulate,
   c. Payment of the benefits is probable, and
   d. The amount of the benefits can be reasonably estimated.

4. If those four conditions are not met, the employer must account for postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 3 only because the amount cannot be reasonably estimated, that fact and the reasons therefore shall be disclosed in the notes to the financial statements.

5. Postemployment benefits provided to employees or agents in connection with their termination can include special termination benefits and contractual termination benefits. Special termination benefits are defined as those that are offered only for a short period of time; contractual termination benefits are defined as those required by the terms of a plan only if a specified event, such as a facility closing, occurs. An employer that offers special termination benefits to employees or agents shall recognize a liability and an expense when the employees or agents accept the offer and the amount can be reasonably estimated. An employer that provides contractual termination benefits shall recognize a liability and an expense when it is probable that employees or agents will be entitled to benefits and the amount can be reasonably estimated. The cost of such termination benefits shall include the amount of any lump-sum payments and the present value of any expected future payments.
6. Accounting changes adopted to conform to the provisions of this issue paper shall be accounted for in accordance with Issue Paper No. 3 - Accounting Changes. In the year the principle is adopted, recognition of the liability for postemployment benefits at the time of adoption that has not previously been recorded shall be recognized through a direct charge to surplus.

Consolidated/Holding Company Plans
7. The employees of many reporting entities are eligible for certain postemployment benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for postemployment benefit obligations, then the requirements outlined in paragraphs 3 to 6 above shall be applied.

DISCUSSION
8. Paragraphs 3 - 6 of the Summary Conclusion above adopt FASB Statement No. 112, Employers’ Accounting for Postemployment Benefits: an amendment of FASB Statements No. 5 and 43 (FAS 112), and the provisions of FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88), that address termination benefits, both with a modification to adopt the principles in accordance with Issue Paper No. 3 - Accounting Changes.

9. The Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) states under the concept of recognition that “Liabilities require recognition as they are incurred” and “Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment”. In addition, the Statement of Concepts states under the concept of conservatism that “In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting”. Requiring reporting entities to follow the guidance in FAS 112 and the termination benefit provisions of FAS 88 is consistent with the recognition and conservatism concepts in the Statement of Concepts.

10. Without guidance on accounting for the cost of postemployment benefits, reporting entities’ accounting for such benefits can vary. FAS 112 notes in paragraph 2 that:

Some employers accrued the estimated cost of those benefits over the related service periods of active employees. Other employers applied a terminal accrual approach and recognized the estimated cost of those benefits at the date of the event giving rise to the payment of the benefits (for example, the death of an active employee, the temporary or permanent disability of an active employee, or the layoff of an employee). Still other employers recognized the cost of postemployment benefits when they were paid (cash basis). Some employers may have used different methods of accounting for different types of benefits.

11. FAS 112 does not provide employers with an option to recognize the effect of adoption over future periods. Paragraph 25 of FAS 112 includes the following statements:

The Board considered whether a provision for delayed recognition of the transition amount was needed. A major objective of transition is to minimize implementation costs and mitigate disruption without unduly compromising the ability of financial statements to provide useful information. An important factor considered by the Board was the potential magnitude of the unrecorded postemployment benefit obligation. Information made available to the Board indicated
that postemployment benefits are generally not as significant as pension or other postretirement benefits. The Board concluded that a provision for delayed recognition was not needed to mitigate the financial statement impact of immediately recognizing the transition amount when this Statement is adopted. That provision would have added unnecessary complexity to the application of this Statement, reduced financial statement comparability, and been inconsistent with Statements 5 and 43, which do not provide for delayed recognition at transition.

This issue paper adopts this immediate recognition concept.

Drafting Notes/Comments
- Accounting for postemployment benefits incurred in connection with a restructuring is addressed in a separate issue paper addressing restructuring costs and EITF 94-3.
- Accounting for pensions is discussed in Issue Paper No. 8 - Accounting for Pensions.
- Accounting for compensated absences is addressed in Issue Paper No. 11 - Compensated Absences.
- Accounting for postretirement benefits other than pensions is addressed in Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions.
- Holding company obligations are addressed in a separate issue paper.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, contains the following with respect to liabilities for benefits for employees and agents:

Liabilities for Benefits for Employees and Agents

A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include:

1. It may be desirable to hold the liability or a nonqualified pension plan in this category in order to assist the tax department in adjusting their tax deductions.

2. The company may wish to set up a liability for the salary for accrued but unused vacation hours since vacation hours can legitimately be viewed as “earned” at the end of the work periods for which they are granted.

Generally Accepted Accounting Principles
13. FAS 112, requires employers to recognize the obligation to provide postemployment benefits in accordance with FASB Statement No. 43, Accounting for Compensated Absences (FAS 43), if the obligation is attributable to employees’ services already rendered, employees’ rights to those benefits accumulate or vest, payment of the benefits is probable, and the amount of the benefits can be reasonably estimated. If those four conditions are not met, the employer should account for postemployment benefits when it is probable that a liability has been incurred and the amount can be reasonably estimated in accordance with FASB Statement No. 5, Accounting for Contingencies (FAS 5). If an obligation for postemployment benefits is not accrued in accordance with FAS 5 or FAS 43 only because the amount cannot be reasonably estimated, the financial statements shall disclose that fact.

14. FAS 88 has provisions that address accounting for benefits provided to employees in connection with their termination of employment. Special termination benefits are defined as those that are offered only for a short period of time and contractual termination benefits are defined as those required by the terms of a plan only if a specified event, such as a plant closing, occurs. FAS 88 requires an employer that offers special termination benefits to employees to recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated. It also requires an employer that provides
contractual termination benefits to recognize a liability and loss when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated. The cost of the termination benefits recognized shall include the amount of any lump-sum payments and the present value of any expected future payments.

**OTHER SOURCES OF INFORMATION**

15. The draft discussion material from previous Life codification projects, Chapter 17, *Other Liabilities*, modified the above language:

   **Liabilities for Benefits for Employees and Agents**

   A company must establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include deferred compensation and nonqualified benefit plans for employees and agents.

16. The NAIC Technical Resource Group proposed draft Life codification Chapter 22, *General Expenses and Taxes, Licenses and Fees*, contains the following guidance:

   **Employee Termination Benefits**

   For a variety of reasons, companies pay compensation to employees at termination. Such benefits include disability benefits, death benefits, severance payments, unemployment benefits, etc. These benefits are paid after an employee terminates but are typically based on service previously rendered.

   The cost of such post-employment benefits must be spread over the working lives of those expected to receive the benefit. These benefits include all benefits paid to or for former or inactive employees (including their beneficiaries and/or dependents) after employment.

   Such compensation must be accrued during an employee’s working life if:

   a. the benefit to be paid is earned for service previously rendered;
   b. the right to those benefits accumulates, vests or;
   c. the payment of the benefits is probable; and
   d. the amount can be reasonably estimated.

17. The draft discussion material from previous Property/Casualty codification projects, Chapter 23, *Non-Claim Operating Expenses*, contains the following language:

   **Salaries, and Employee Relations and Welfare (Including Post Employment Retirement and Other Benefits)**

   Salaries and payroll related expenses are usually the second largest expense for most insurance companies. SAP requires that salaries and related expenses be accounted for under the accrual basis of accounting (i.e., expense recorded when incurred and not when paid). Pensions and other post retirement benefit plans for which there is no promulgated SAP should be accounted for in accordance with GAAP as promulgated by the Financial Accounting Standards Board (FASB). (The preceding may need revision based on final outcome of the FASB 106 Task Force.)

   Employee compensation and post retirement benefits include, among other things, the following:

   1. Salaries and wages
   2. Pension plans.
   3. Post retirement benefits other than pensions.
   5. Stock purchase and option plans.
   6. Other deferred compensation
18. In addition, the draft discussion materials from previous Property/Casualty codification projects discusses deferred compensation and special termination benefits specifically and states the following:

Other Deferred Compensation

The accounting for other deferred compensation arrangements, which do not constitute pension plans is governed by APB Opinion No. 12, “Omnibus Opinion”. APB 12 provides that deferred compensation contracts should be accounted separately for each employee on the accrual basis. The amount of each accrual cannot be less than the present value of the benefits to be provided (including benefits to beneficiaries) by the terms of the contract. The accruals should be made over the employee’s employment period.

Special Termination Benefits

FASB 74 “Accounting for Special Termination Benefits Paid to Employees” [FAS 74] provides that,

... an employer that offers for a short period of time special termination benefits to employees shall recognize a liability and an expense when the employees accept the offer and the amount can be reasonable estimated. The amount shall include any lump sum payments and the present value of any expected future payments.

These arrangements may also effect the estimated costs of pension benefits.

19. It should be noted that although FAS 74 has been superseded by FAS 88, the conclusions reached in FAS 74 were incorporated into FAS 88 (i.e., the cost of special termination benefits should be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonable estimated). See paraphrasing from FAS 88 in the Generally Accepted Accounting Principles section of this paper.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, subcaption - Liabilities for Benefits for Employees and Agents, page 17-1
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities, subcaption - Postretirement Benefits Other Than Pensions, page 17-3
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities, subcaption - Postretirement Benefits Other Than Pensions, page 13-3

Generally Accepted Accounting Principles
- FASB Statement No. 112, Employers’ Accounting for Postemployment Benefits an amendment of FASB Statements No. 5 and 43
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 43, Accounting for Compensated Absences
- FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Draft discussion material from previous Property/Casualty codification projects, Chapter 23, *Non-Claim Operating Expenses*, subcaption - Pension Plans
- Draft discussion material from previous Life codification projects, Chapter 17, *Other Liabilities*, subcaption - Liabilities for Benefits for Employees and Agents, page 17.2
Statutory Issue Paper No. 14
Employers’ Accounting for Postretirement Benefits Other Than Pensions

STATUS
Finalized December 6, 1999

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Postretirement benefits include all forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits. Current statutory accounting addresses employers’ accounting for postretirement benefits other than pensions.

2. GAAP guidance has been established by FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions (FAS 106), and differs from the current statutory guidance. FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (FAS 132), specifies disclosure requirements for pension and other postretirement benefit plans.

3. The purpose of this issue paper is to establish statutory accounting principles for postretirement benefits other than pensions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Employers’ accounting for postretirement benefits other than pensions under statutory accounting shall be consistent with existing statutory guidance in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. The principles contained therein shall apply to postretirement benefits other than pensions for all eligible and vested employees and vested former employees including their beneficiaries and covered dependents, pursuant to the terms of an employer's undertaking to provide those benefits. Any asset resulting from an overfunding of the plan shall be recorded as a nonadmitted asset.

Disclosure
5. The disclosures required by paragraph 5 of FAS 132 shall be included in the notes to the statutory financial statements considering the modification in this issue paper to include only vested employees. Paragraph 5 of FAS 132 is included in the Relevant GAAP Guidance section of this issue paper. The disclosures required by paragraph 5 of FAS 132 shall be made when an employer recognizes a gain or loss related to a settlement or curtailment of a defined benefit plan or when providing termination benefits.

Consolidated/Holding Company Plans
6. The employees of many reporting entities are eligible for certain postretirement benefits other than pensions provided by a parent company or holding company. A reporting entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. The reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of the postretirement benefit expense incurred and
the allocation methodology shall also be disclosed in the financial statements. If the reporting entity is directly liable for certain postretirement benefits other than pensions, then the requirements outlined in paragraphs 4 and 5 of this issue paper shall be applied.

DISCUSSION

7. Current statutory accounting and the accounting codified within this issue paper adopt FAS 106, FAS 132 and Accounting Principles Board Opinion No. 12, Omnibus Opinion–1967, paragraphs 6 through 8 with the following modifications:

a. Any asset which results from an excess of the fair value of plan assets over the postretirement benefit obligation shall be recorded as a nonadmitted asset.

b. Calculation of the postretirement benefit obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts.

c. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132.

d. Disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for income on a statutory basis.

8. This issue paper adopts FASB Emerging Issues Task Force No. 93-3, Plan Assets under FASB Statement No. 106.

9. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies address employers’ accounting for postretirement benefits other than pensions and require that the obligation for such benefits be recognized on an accrual basis for current retirees and fully eligible or vested employees. If the fair value of plan assets exceeds the postretirement obligation and a transition asset results, the asset is considered a nonadmitted asset. At transition, the employer may elect to recognize the unfunded postretirement benefit obligation as a charge to statutory surplus in the period of adoption or amortize it as a component of net periodic postretirement benefit cost over a period of up to twenty years.

10. GAAP guidance is established by FAS 106 and differs from the current statutory guidance in that it requires the accrual of expected postretirement benefits for all current and former employees (including retirees, disabled employees, and other former employees who are expected to receive postretirement benefits), their beneficiaries, and covered dependents, pursuant to the terms of an employer’s undertaking to provide those benefits. Two options are provided for recognizing the transition obligation. An employer may choose to immediately recognize the transition obligation as the effect of a change in accounting principle, subject to certain limitations. Alternatively, an employer may choose to recognize the transition obligation on a delayed basis over the plan participants' future service periods, with disclosure of the unrecognized amount. However, that delayed recognition cannot result in less rapid recognition than accounting for the transition obligation on a pay-as-you-go basis.

11. The Statement of Concepts states under the recognition concept that “Liabilities require recognition as they are incurred” and “Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.” In addition, the Statement of Concepts states under the concept of conservatism that “In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.” Requiring reporting entities to follow the existing statutory guidance relative to accounting for postretirement benefits other than pensions is consistent with the recognition and conservatism concepts in the Statement of Concepts.
Drafting Notes/Comments
- Federal income taxes are addressed in a separate issue paper.
- Holding company obligations are addressed in a separate issue paper.
- Accounting for pensions is addressed in Issue Paper No. 8 - Accounting for Pensions.
- Accounting for postemployment benefits is addressed in Issue Paper No. 13 - Employers’ Accounting for Postemployment Benefits.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. The following is an excerpt from the Accounting Practices and Procedures Manuals for Life and Accident and Health [Chapter 17] and for Property and Casualty [Chapter 13] Insurance Companies:

Postretirement Benefits Other Than Pensions

Postretirement benefits are all forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits.

An employer shall account for its postretirement benefits on an accrual basis. The postretirement benefit obligation for current retirees and fully eligible or vested employees at transition (initial adoption date*) is measured by estimating the actuarial present value of benefits expected to be received at retirement using explicit assumptions. A health care cost trend rate assumption is used in the estimation. A health care cost trend rate is an assumption about the annual rate(s) of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the composition of the plan population by age and dependency status, for each year from the measurement date until the end of the period in which benefits are expected to be paid. The health care cost trend rates implicitly consider estimates of health care inflation, changes in health care utilization or status of the plan participants.

* For most companies, the transition or initial adoption date is January 1, 1993. For companies whose plans are outside the United States and for defined benefits of employers with no more than 500 plan participants in the aggregate, the transition or initial adoption is January 1, 1995.

Plan assets, if any, shall be segregated or restricted, and measured at fair value.

At transition, an employer may elect to recognize the unfunded postretirement benefit obligation immediately in statutory surplus or amortize it as a component of net periodic postretirement benefit cost over a period of up to twenty years.

In each period, estimated postretirement benefits for newly eligible or vested employees shall be accrued at eligibility date ("estimated eligibility cost"). Interest cost on the postretirement benefit obligation at the beginning of the period shall be recognized during the period. Actuarial gains and losses (other than plan asset gains and losses) arising from differences between assumptions and actual experience upon subsequent remeasurement of the obligation may be recognized as a component of the net periodic postretirement benefit cost in the current period or amortized. The net actuarial gain or loss shall be included as a component of the net periodic postretirement benefit cost for a year, if, as of the beginning of the year, that unrecognized net gain or loss exceeds 10 percent of the greater of the postretirement benefit obligation or the fair value of plan assets. That gain or loss, if not recognized immediately, shall be amortized over the average life expectancy of the employer's fully vested and retiree group. The method elected must be consistently applied.
Gains or Losses On Plan Assets:

Plan asset gains and losses are differences between the actual return on plan assets (including changes in the fair values of plan assets) during a period and the expected return on plan assets for that period. Amortization of an unrecognized net asset gain or loss shall be included as a component of net postretirement benefit cost for a year if, as of the beginning of the year, that unrecognized net gain or loss exceeds 10 percent of the greater of the postretirement benefit obligation or the fair value of plan assets. That excess shall be amortized over the average life expectancy of the employer's fully vested and retiree group.

Plan amendments:

Plan amendments may include provisions that increase or reduce benefits to retirees and fully eligible employees. The cost of benefit improvements is the increase in the postretirement benefit obligation as a result of the plan amendment, measured at the date of the amendment. That increase shall be amortized over the average life expectancy of the employer's fully vested and retiree group.

A plan amendment can reduce, rather than increase, the postretirement benefit obligation. A reduction in that obligation shall first reduce any existing unrecognized plan amendment cost, and then, reduce any remaining unrecognized transition obligation. The excess, if any, shall be amortized on the same basis as plan amendments that increase benefits.

Financial Statement Presentation:

The net periodic postretirement benefit cost (i.e., the estimated eligibility cost, interest cost, actuarial gains or losses, and any amortization costs) shall be reflected in the income statement. If an employer elects immediate recognition of the initial transition obligation, it shall be accounted for as a change of accounting method (i.e., the initial transition obligation is recorded as an adjustment to statutory surplus).

Transition Asset:

If the fair value of plan assets exceeds the postretirement obligation and a transition asset results, the asset shall be considered a nonadmitted asset.

Defined Contribution Plans:

A defined contribution postretirement benefit plan is a plan that provides postretirement benefits by establishing an individual account for each participant and has terms that specify how contributions to the individual's account are to be determined rather than the amount of postretirement benefits the individual is to receive. Under a defined contribution plan, postretirement benefits a plan participant will receive are limited to the amount contributed to the plan participant's account, the returns earned on investments of these contributions, and forfeitures of other plan participants' benefits that may be allocated to the plan participant's account.

To the extent that an employer's defined contributions to an individual's account are vested or irrevocable, the net postretirement benefit cost for a period shall be the contribution called for in that period. If a plan calls for contributions for periods after an individual retires, the estimated costs shall be accrued at retirement date.

Effective Date:

This policy shall be effective for the first quarter financial statements dated March 31, 1993, except that plans outside the United States and for defined benefit plans of employees with no more than 500 plan participants in the aggregate, this policy shall be effective for 1st quarter financial statements dated March 31, 1995.
13. The NAIC Annual Statement Instructions (Annual Statement Instructions) for Life and Accident and Health Insurance Companies contain the following language related to Liabilities, Surplus and Other Funds:

   Line 13 - General Expenses Due or Accrued

   Include: Expenses not yet incurred but which it is anticipated will be incurred in connection with accident and health claims at the year-end.

   Unfunded postretirement benefit obligation.

14. The Annual Statement Instructions also include the following language with respect to Capital and Surplus Account:

   Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus

   Report separately any other changes to Capital and Surplus, not included above, including amounts received for subordinated surplus debentures.

   Include: The initial transition obligation for unfunded postretirement benefit obligation if a company elects to immediately recognize such obligation.

   (Charges) or credits for extraordinary amounts of taxes (including interest) paid or accrued in prior years.

   (Charges) or credits for extraordinary amounts of expenses paid or accrued in prior years.

   (See Item 7 on Page d of these instructions.)

15. In addition, the Annual Statement Instructions for Exhibit 5 - General Expenses state:

   Line 3.31 - Other Employee Welfare
   Line 3.32 - Other Agent Welfare

   Expenses included in this line may be reported on a functional basis.

   Include: The net periodic postretirement benefit cost.

   Meals to employees. (Companies so desiring may exclude this item from Other Employee Welfare or Other Agent Welfare and include it under Details Aggregated on Line 9.3 for Expenses.)

   Contributions to employee associations or clubs.

16. The Annual Statement Instructions also provide guidance on information to be included in the notes to the financial statements:

   6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans Instruction:

   c. Postretirement Benefit Plans

   Include the following:

   A description of the plan(s).

   A description of the plan's policy.
The method of determination and the amount of postretirement benefit expense.

The amount of the postretirement benefit obligation for retirees and fully eligible or vested employees and the fair value of the plan assets valued as of the most recent actuarial valuation date.

The amount of the postretirement benefit obligation included on Page 3, Line 13 [Life and Accident and Health] or Lines 2 and 4 [Property and Casualty].

The amount of the postretirement obligation for non vested employees as of the most recent actuarial date.

The discount and health care cost trend rate used in the estimations.

The effect of a one-percentage-point increase in the assumed health care cost trend rates for each future year on (1) the aggregate of the estimated eligibility and interest cost components of net periodic postretirement benefit cost and (2) the postretirement benefit obligation for health care benefits (for purposes of this disclosure, all other assumptions shall be held constant and the effects shall be measured based upon the substantive plan that is the basis of accounting).

Significant matters affecting the year-to-year comparability of the plan information.

An employer who is a member of a multi-employer plan shall disclose a description of the plan(s), the method of determination and the amount of postretirement benefit expense for the employer/member and the unfunded postretirement benefit obligation.

Postretirement Defined Contribution Plans
Include the following:

A description of the plans, including employee groups covered.

The basis for determining contributions.

The nature and effect of significant matters affecting comparability of information for all periods presented.

The amount of cost recognized during the period.

Sample disclosure is also provided.

17. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies includes the following language with respect to Underwriting and Investment Exhibit - Part 4 - Expenses:

The total management fees and the method(s) used for allocation shall be disclosed in the Notes to Financial Statements. The company shall use the same allocation method(s) on a consistent basis.

Line 9 - Employee Relations and Welfare

Include: The net periodic postretirement benefit cost.
Generally Accepted Accounting Principles
18. The following summary from FAS 106, describes the GAAP methodology and concepts:

Summary

This Statement establishes accounting standards for employers' accounting for postretirement benefits other than pensions (hereinafter referred to as postretirement benefits). Although it applies to all forms of postretirement benefits, this Statement focuses principally on postretirement health care benefits. It will significantly change the prevalent current practice of accounting for postretirement benefits on a pay-as-you-go (cash) basis by requiring accrual, during the years that the employee renders the necessary service, of the expected cost of providing those benefits to an employee and the employee's beneficiaries and covered dependents.

The Board's conclusions in this Statement result from the view that a defined postretirement benefit plan sets forth the terms of an exchange between the employer and the employee. In exchange for the current services provided by the employee, the employer promises to provide, in addition to current wages and other benefits, health and other welfare benefits after the employee retires. It follows from that view that postretirement benefits are not gratuities but are part of an employee's compensation for services rendered. Since payment is deferred, the benefits are a type of deferred compensation. The employer's obligation for that compensation is incurred as employees render the services necessary to earn their postretirement benefits.

The ability to measure the obligation for postretirement health care benefits and the recognition of that obligation have been the subject of controversy. The Board believes that measurement of the obligation and accrual of the cost based on best estimates are superior to implying, by a failure to accrue, that no obligation exists prior to the payment of benefits. The Board believes that failure to recognize an obligation prior to its payment impairs the usefulness and integrity of the employer's financial statements.

The Board's objectives in issuing this Statement are to improve employers' financial reporting for postretirement benefits in the following manner:

a. To enhance the relevance and representational faithfulness of the employer's reported results of operations by recognizing net periodic postretirement benefit cost as employees render the services necessary to earn their postretirement benefits

b. To enhance the relevance and representational faithfulness of the employer's statement of financial position by including a measure of the obligation to provide postretirement benefits based on a mutual understanding between the employer and its employees of the terms of the underlying plan

c. To enhance the ability of users of the employer's financial statements to understand the extent and effects of the employer's undertaking to provide postretirement benefits to its employees by disclosing relevant information about the obligation and cost of the postretirement benefit plan and how those amounts are measured

d. To improve the understandability and comparability of amounts reported by requiring employers with similar plans to use the same method to measure their accumulated postretirement benefit obligations and the related costs of the postretirement benefits.

Similarity to Pension Accounting

The provisions of this Statement are similar, in many respects, to those in FASB Statements No. 87, Employers' Accounting for Pensions, and No. 88, Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits. To the extent the promise to provide pension benefits and the promise to provide postretirement benefits are similar, the provisions of this Statement are similar to those prescribed by Statements 87 and 88;
different accounting treatment is prescribed only when the Board has concluded that there is a compelling reason for different treatment. Appendix B identifies the major similarities and differences between this Statement and employers' accounting for pensions.

Basic Tenets

This Statement relies on a basic premise of generally accepted accounting principles that accrual accounting provides more relevant and useful information than does cash basis accounting. The importance of information about cash flows or the funding of the postretirement benefit plan is not ignored. Amounts funded or paid are given accounting recognition as uses of cash, but the Board believes that information about cash flows alone is insufficient. Accrual accounting goes beyond cash transactions and attempts to recognize the financial effects of noncash transactions and events as they occur. Recognition and measurement of the accrued obligation to provide postretirement benefits will provide users of financial statements with the opportunity to assess the financial consequences of employers' compensation decisions.

In applying accrual accounting to postretirement benefits, this Statement adopts three fundamental aspects of pension accounting: delayed recognition of certain events, reporting net cost, and offsetting liabilities and related assets.

Delayed recognition means that certain changes in the obligation for postretirement benefits, including those changes arising as a result of a plan initiation or amendment, and certain changes in the value of plan assets set aside to meet that obligation are not recognized as they occur. Rather, those changes are recognized systematically over future periods. All changes in the obligation and plan assets ultimately are recognized unless they are first reduced by other changes. The changes that have been identified and quantified but not yet recognized in the employer's financial statements as components of net periodic postretirement benefit cost and as a liability or asset are disclosed.

Net cost means that the recognized consequences of events and transactions affecting a postretirement benefit plan are reported as a single amount in the employer's financial statements. That single amount includes at least three types of events or transactions that might otherwise be reported separately. Those events or transactions -- exchanging a promise of deferred compensation in the form of postretirement benefits for employee service, the interest cost arising from the passage of time until those benefits are paid, and the returns from the investment of plan assets -- are disclosed separately as components of net periodic postretirement benefit cost.

Offsetting means that plan assets restricted for the payment of postretirement benefits offset the accumulated postretirement benefit obligation in determining amounts recognized in the employer's statement of financial position and that the return on those plan assets offsets postretirement benefit cost in the employer's statement of income. That offsetting is reflected even though the obligation has not been settled, the investment of the plan assets may be largely controlled by the employer, and substantial risks and rewards associated with both the obligation and the plan assets are borne by the employer.

Recognition and Measurement

The Board is sensitive to concerns about the reliability of measurements of the postretirement health care benefit obligation. The Board recognizes that limited historical data about per capita claims costs are available and that actuarial practice in this area is still developing. The Board has taken those factors into consideration in its decisions to delay the effective date for this Statement, to emphasize disclosure, and to permit employers to phase in recognition of the transition obligation in their statements of financial position. However, the Board believes that those factors are insufficient reason not to use accrual accounting for postretirement benefits in financial reporting. With increased experience, the reliability of measures of the obligation and cost should improve.
An objective of this Statement is that the accounting reflect the terms of the exchange transaction that takes place between an employer that provides postretirement benefits and the employees who render services in exchange for those benefits. Generally the extant written plan provides the best evidence of that exchange transaction. However, in some situations, an employer's cost-sharing policy, as evidenced by past practice or by communication of intended changes to a plan's cost-sharing provisions, or a past practice of regular increases in certain monetary benefits may indicate that the substantive plan -- the plan as understood by the parties to the exchange transaction -- differs from the extant written plan. The substantive plan is the basis for the accounting.

This Statement requires that an employer's obligation for postretirement benefits expected to be provided to or for an employee be fully accrued by the date that employee attains full eligibility for all of the benefits expected to be received by that employee, any beneficiaries, and covered dependents (the full eligibility date), even if the employee is expected to render additional service beyond that date. That accounting reflects the fact that at the full eligibility date the employee has provided all of the service necessary to earn the right to receive all of the benefits that employee is expected to receive under the plan.

The beginning of the attribution (accrual) period is the employee's date of hire unless the plan only grants credit for service from a later date, in which case benefits are generally attributed from the beginning of that credited service period. An equal amount of the expected postretirement benefit obligation is attributed to each year of service in the attribution period unless the plan attributes a disproportionate share of the expected benefits to employees' early years of service. The Board concluded that, like accounting for other deferred compensation agreements, accounting for postretirement benefits should reflect the explicit or implicit contract between the employer and its employees.

Single Method

The Board believes that understandability, comparability, and usefulness of financial information are improved by narrowing the use of alternative accounting methods that do not reflect different facts and circumstances. The Board has been unable to identify circumstances that would make it appropriate for different employers to use fundamentally different accounting methods or measurement techniques for similar postretirement benefit plans or for a single employer to use fundamentally different methods or measurement techniques for different plans. As a result, a single method is prescribed for measuring and recognizing an employer's accumulated postretirement benefit obligation.

Amendment to Opinion 12

An employer's practice of providing postretirement benefits to selected employees under individual contracts, with specific terms determined on an individual-by-individual basis, does not constitute a postretirement benefit plan under this Statement. This Statement amends APB Opinion No. 12, Omnibus Opinion--1967, to explicitly require that an employer's obligation under deferred compensation contracts be accrued following the terms of the individual contract over the required service periods to the date the employee is fully eligible for the benefits.

Transition

Unlike the effects of most other accounting changes, a transition obligation for postretirement benefits generally reflects, to a considerable extent, the failure to accrue the accumulated postretirement benefit obligation in earlier periods as it arose rather than the effects of a change from one acceptable accrual method of accounting to another. The Board believes that accounting for transition from one acceptable accrual method of accounting to another is a practical matter and that a major objective of that accounting is to minimize the cost and mitigate the disruption to the extent possible without unduly compromising the ability of financial statements to provide useful information.
This Statement measures the transition obligation as the unfunded and unrecognized accumulated postretirement benefit obligation for all plan participants. Two options are provided for recognizing that transition obligation. An employer can choose to immediately recognize the transition obligation as the effect of an accounting change, subject to certain limitations. Alternatively, an employer can choose to recognize the transition obligation in the statement of financial position and statement of income on a delayed basis over the plan participants' future service periods, with disclosure of the unrecognized amount. However, that delayed recognition cannot result in less rapid recognition than accounting for the transition obligation on a pay-as-you-go basis.

Effective Dates

This Statement generally is effective for fiscal years beginning after December 15, 1992, except that the application of this Statement to plans outside the United States and certain small, nonpublic employers is delayed to fiscal years beginning after December 15, 1994. The amendment of Opinion 12 is effective for fiscal years beginning after March 15, 1991.

19. FAS 132 sets forth disclosure requirements:

Disclosures about Pensions and Other Postretirement Benefits

5. An employer that sponsors one or more defined benefit pension plans or one or more defined benefit postretirement plans shall provide the following information:

a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to each of the following: service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits

For defined benefit pension plans, the benefit obligation is the projected benefit obligation—the actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. For defined benefit postretirement plans, the benefit obligation is the accumulated postretirement benefit obligation—the actuarial present value of benefits attributed to employee service rendered to a particular date.

The effects of foreign currency exchange rate changes that are to be disclosed are those applicable to plans of a foreign operation whose functional currency is not the reporting currency pursuant to FASB Statement No. 52, Foreign Currency Translation.

b. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to each of the following: actual return on plan assets, foreign currency exchange rate changes, contributions by the employer, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements

Refer to footnote 3.

c. The funded status of the plans, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:

(1) The amount of any unamortized prior service cost
(2) The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)
(3) The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of Statement 87 or 106

(4) The net pension or other postretirement benefit prepaid assets or accrued liabilities

(5) Any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended

d. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized transition obligation or transition asset, the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment

e. The amount included within other comprehensive income for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended

f. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets

g. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved

h. The effect of a one-percentage-point increase and the effect of a one-percentage-point decrease in the assumed health care cost trend rates on (1) the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost and (2) the accumulated postretirement benefit obligation for health care benefits (For purposes of this disclosure, all other assumptions shall be held constant, and the effects shall be measured based on the substantive plan that is the basis for the accounting.)

i. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period

j. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of Statement 87 or paragraphs 53 and 60 of Statement 106

k. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation

l. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event

m. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this Statement.

Amounts related to the employer’s results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the employer’s statement of financial position shall be disclosed for each balance sheet presented.

Employers with Two or More Plans

6. The disclosures required by this Statement may be aggregated for all of an employer's defined benefit pension plans and may be aggregated for all of an employer’s defined benefit postretirement plans or may be disaggregated in groups if that is considered to provide the most useful information or is otherwise required by paragraph 7. Disclosures about pension plans with assets in excess of the accumulated benefit obligation generally may be aggregated with disclosures about pension plans with accumulated benefit obligations in excess of assets. The same aggregation is permitted for postretirement plans. However, if those disclosures are combined, an employer shall disclose the aggregate benefit obligation and aggregate fair value of plan assets for plans with benefit obligations in excess of plan assets. The aggregate pension
accumulated benefit obligation and aggregate fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets also shall be disclosed. Disclosure of amounts recognized in the statement of financial position shall present prepaid benefit costs and accrued benefit liabilities separately.

7. An employer may combine disclosures about pension or postretirement benefit plans outside the United States with those for U.S. plans unless the benefit obligations of the plans outside the United States are significant relative to the total benefit obligation and those plans use significantly different assumptions.

Reduced Disclosure Requirements for Nonpublic Entities

8. A nonpublic entity\(^5\) may elect to disclose the following for its pension and other postretirement benefit plans in lieu of the disclosures required by paragraph 5 of this Statement:

\(^5\) A nonpublic entity is any entity other than one (a) whose debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market, or (c) that is controlled by an entity covered by (a) or (b).

a. The benefit obligation, fair value of plan assets, and funded status of the plan
b. Employer contributions, participant contributions, and benefits paid
c. The amounts recognized in the statement of financial position, including the net pension and other postretirement benefit prepaid assets or accrued liabilities and any intangible asset and the amount of accumulated other comprehensive income recognized pursuant to paragraph 37 of Statement 87, as amended
d. The amount of net periodic benefit cost recognized and the amount included within other comprehensive income arising from a change in the minimum pension liability recognized pursuant to paragraph 37 of Statement 87, as amended
e. On a weighted-average basis, the following assumptions used in the accounting for the plans: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets
f. The assumed health care cost trend rate(s) for the next year used to measure the expected cost of benefits covered by the plan (gross eligible charges) and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved
g. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer or related parties, and any significant transactions between the employer or related parties and the plan during the period
h. The nature and effect of significant nonroutine events, such as amendments, combinations, divestitures, curtailments, and settlements.

Defined Contribution Plans

9. An employer shall disclose the amount of cost recognized for defined contribution pension or other postretirement benefit plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

Multiemployer Plans

10. An employer shall disclose the amount of contributions to multiemployer plans during the period. An employer may disclose total contributions to multiemployer plans without
disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

11. Paragraph 70 of Statement 87 and paragraph 83 of Statement 106 are carried forward without reconsideration. Paragraphs 70 and 83 read as follows:

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of its unfunded benefit obligations. If withdrawal under circumstances that would give rise to an obligation is either probable or reasonably possible, the provisions of FASB Statement No. 5, Accounting for Contingencies, shall apply.

In some situations, withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation. If it is either probable or reasonably possible that (a) an employer would withdraw from the plan under circumstances that would give rise to an obligation or (b) an employer's contribution to the fund would be increased during the remainder of the contract period to make up a shortfall in the funds necessary to maintain the negotiated level of benefit coverage (a "maintenance of benefits" clause), the employer shall apply the provisions of FASB Statement No. 5, Accounting for Contingencies.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles
- FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions
- FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits
- FASB Emerging Issues Task Force No. 93-3, Plan Assets under FASB Statement No. 106
- Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967, paragraphs 6 through 8

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 16
Electronic Data Processing Equipment and Software

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current statutory guidance provides that some states permit recording electronic data processing (EDP) equipment and operating system software as admitted assets. This is subject to limitations such as a percentage of total assets, minimum purchase price, and period of depreciation. Application system software may be expensed when purchased, or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life.

2. GAAP requires purchases of EDP equipment and software to be capitalized and depreciated over the expected useful lives of the assets, except for software purchased or leased for research and development purposes, which is required to be expensed at acquisition. There is no authoritative literature in GAAP that addresses capitalization of software developed for internal use, and industry practice is mixed. This issue paper establishes a framework for the accounting and reporting of EDP equipment and software that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. EDP equipment and software generally meet the definition of an asset in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. EDP equipment and operating system software are admitted assets to the extent they conform to the requirements of this issue paper. Nonoperating system software meet the criteria defining nonadmitted assets; accordingly, such assets shall be reported as nonadmitted assets and charged against surplus.

4. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements.

5. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity’s capital and surplus, excluding from capital and surplus any EDP equipment and operating system software, net deferred tax assets and net positive goodwill, as of the financial statement date.

6. The following disclosures shall be made in the financial statements:
   a. Depreciation and amortization expense for the period;
   b. For EDP equipment and operating system software, balances of major classes of depreciable assets, by nature or function, at the balance sheet date;
   c. For EDP equipment and operating system software, accumulated depreciation and amortization, either by major classes of depreciable assets or in total, at the balance sheet date; and
d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

DISCUSSION

7. Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets states that an asset not readily available to satisfy policyholder obligations “shall be recorded as a nonadmitted asset and charged against surplus.” This is consistent with the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.”

8. EDP equipment and operating system software meet the criteria defining admitted assets because they generally have a resale value. The limitation of the depreciation period to three years is deemed appropriate due to the current evolutionary period for such equipment and software. Additionally, the limitation on the amount of EDP equipment and operating system software which may be admitted in an amount not to exceed three percent of capital and surplus (as adjusted by EDP equipment and operating system software, net deferred tax assets and net positive goodwill) is consistent with the conservatism concept of the Statement of Concepts.

9. Nonoperating system software is not considered readily available to satisfy policyholder obligations, particularly due to the nature of internally developed EDP software and the modifications made to purchased EDP software, that make it tailored for use only on the owner's computer system, thereby rendering it unable to be readily resold. Nonadmitting nonoperating software is also consistent with the conservatism concept of the Statement of Concepts.

Drafting Notes/Comments
- FASB Statement No. 2, Accounting for Research and Development Costs (FAS 2), FASB Interpretation No. 6, Applicability of FASB Statement No. 2 to Computer Software (FIN 6) and FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed (FAS 86) are addressed in Issue Paper No. 17 - Preoperating and Research and Development Costs.
- Furniture, fixtures & equipment are addressed in Issue Paper No. 19 - Furniture, Fixtures and Equipment.
- Leases and sale-leaseback transactions are addressed in Issue Paper No. 22 - Leases

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8, Other Admitted Assets, differentiates between operating software and applications software as follows:

1. Various states permit showing the depreciated value of electronic data processing apparatus and related equipment constituting a data processing record keeping or accounting system as an asset. This is subject to limitations such as a percentage of total assets, minimum purchase price and period of depreciation. Operating system software may also qualify as an asset. The operating system is a program or series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices. Applications systems software such as language processors, library routines and debugging aides and other computer software are not considered operating system software and may not be recognized as admitted assets.
11. Chapter 9, Nonadmitted Assets, states: “application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software's expected useful life.”


13. In most states the depreciated value of EDP equipment and its related operating software is an admitted asset, generally subject to several restrictions. The restrictions could include the following: requiring permission from the insurance commissioner of the state of domicile, setting a minimum amount that can be capitalized as an asset, establishing a maximum depreciable life (such as 10 years for hardware and five years for software) and limiting the amount that may be admitted to a percentage of total admitted assets or capital and surplus. Applications software is typically nonadmitted.

**Generally Accepted Accounting Principles**

14. GAAP requires purchases of long-lived equipment to be capitalized at their historical cost and depreciated over the expected useful life of the assets by recording a monthly charge against current income, in accordance with Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43), Chapter 9, *Depreciation*. This treatment is consistent with the matching concept of GAAP, which requires revenues and expenses to be recognized over the period in which they are earned or incurred.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapters 8 and 9
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapters 8 and 9
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements

**State Regulations**
- California Statutes - Insurance Laws, Division 1, Part 2, Article 4, *Property Authorized for Excess Funds Investments*
- New York Statutes - Insurance Laws, Chapter 28, Article 13, *Assets and Deposits*
- Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance*, subchapter A. Terms Defined; Domestic Companies
- Texas Administrative Code, Title 28, Part I, Chapter 7, *Corporate and Financial*
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Statutory Issue Paper No. 17
Preoperating and Research and Development Costs

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses organizational costs, research and development costs and start-up costs for new and existing entities. Current statutory accounting guidance does not specifically address the treatment of such costs. Standard statutory practice is to expense these costs as incurred. GAAP specifically addresses the treatment of research and development costs and costs of development stage enterprises. GAAP provides limited guidance on the treatment of other organizational costs resulting in varied practices.

2. The purpose of this issue paper is to establish specific statutory accounting principles related to preoperating and research and development costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Preoperating, including organization and start up costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (1) arranging operations for a new company (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock); (2) establishing production, sales or service facilities at a new site; (3) changing operations or production significantly; or (4) developing and producing a new product, adopting a new process or offering a new service. Preoperating, including organization and start up costs, and research and development costs specifically exclude tangible assets acquired in connection with such activities.

DISCUSSION

4. This issue paper adopts FASB Statement No. 2, Accounting for Research and Development Costs (FAS 2) and the related FASB Interpretation No. 6, Applicability of FASB Statement No. 2 To Computer Software (FIN 6) and rejects FASB Statement No. 7, Accounting and Reporting by Development Stage Enterprises (FAS 7). This issue paper also adopts FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed (FAS 86), with the exception of paragraphs 5 and 6 and paragraphs 8 through 11, which are rejected.

5. Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Although in some instances preoperating and research and development costs may appear to comply with the definition of an asset established by Issue Paper No. 4, it is not consistent with the Conservatism concept included in the Statement of Concepts to estimate that it is “probable” that an entity in a preoperating phase or a new product still being developed will generate future economic benefits. Preoperating and research and development costs, therefore, do not meet the definition of an asset for statutory accounting purposes and as such should be expensed as incurred. This is consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.”
6. FAS 2 requires research and development costs (e.g., costs related to the development of an insurance product providing a new form of coverage or modifications to an existing insurance product) to be expensed as incurred. FAS 7 specifies that the accounting of the cost of a development stage enterprise should be no different than the accounting for similar costs of a mature enterprise. FAS 7 requires that the recoverability of costs incurred by a development stage enterprise be assessed in order to identify which costs qualify for capitalization or deferral. It permits recognition of these costs as an asset if they meet the GAAP criteria for capitalization. Other organizational costs are not specifically addressed in GAAP literature resulting in varied practices. Companies which have capitalized these costs do so under the matching concept of relating costs to revenue. Under this theory, revenue will be realized through future operations and therefore the costs should be deferred and expensed in the future when the revenue is recognized. Because the future benefit is rarely certain or measurable and the future period over which deferred costs might be allocated is usually arbitrary, deferral is not consistent with the Conservatism and Recognition concepts included in the Statement of Concepts.

7. FAS 86 reaffirms the provisions of FAS 2 for the treatment of software developed to be sold, leased or otherwise marketed by requiring the related software development costs to be expensed as incurred, with the exception of software costs incurred subsequent to the research and development phase but prior to making the software available to the public. Paragraphs 5, 6 and 8 through 11 of FAS 86 allow these costs to be capitalized. For the purposes of this paper, these costs are not considered to be different from the other costs incurred during a preoperating or research and development period and are included in the conclusion to expense these costs as incurred.

Drafting Notes/Comments
- Accounting treatment of goodwill, real estate, EDP equipment and software and furniture and equipment are addressed in separate issue papers.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. The majority of states do not specifically address the admission of preoperating costs in their insurance regulations and statutes. Typically, a reference is made to the treatment of goodwill and all other intangible assets. An example of this type of state guidance is New York Statutes - Insurance Laws, Chapter 28 of the Consolidated Insurance Laws, Article 13, Assets and Deposits, which states:

The following shall not be allowed as admitted assets of a domestic or foreign insurer or the United States branch of an alien insurer in any determination of its financial condition:

(1) Goodwill, trade names, agency plants and other like intangible assets.

9. Several states do make specific reference to organization costs in their insurance regulations and statutes. For example, Maryland Insurance Statutes - Insurance Laws, Article 48A -- Insurance Code, Subtitle 5, Assets and Liabilities, explicitly requires the nonadmission of organization costs, as opposed to expensing them as incurred.

Generally Accepted Accounting Principles
10. FAS 2, paragraph 12, states that “All research and development costs encompassed by this Statement shall be charged to expense when incurred.”

11. FAS 2 contains the following definitions:

8. For purposes of this Statement, research and development is defined as follows:

a) Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter ‘product’) or a new process or technique.
b) Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.

12. FIN 6, paragraph 5, states:

When software for use in research and development activities is purchased or leased, its cost shall be accounted for as specified by paragraphs 11(c) and 12 of Statement No. 2. That is, the cost shall be charged to expense as incurred unless the software has alternative future uses (in research and development or otherwise).

13. FAS 86 amends FAS 2 and FIN 6 to provide guidance on accounting for software developed internally for sale, lease or other marketing. FAS 86, paragraph 3, states:

All costs incurred to establish the technological feasibility of a computer software product to be sold, leased, or otherwise marketed are research and development costs. These costs shall be charged to expense when incurred as required by FASB Statement No. 2, Accounting for Research and Development Costs.

14. FAS 86, paragraphs 5 and 6, addresses the treatment of the costs of internally developed software that has completed the research and development phase but has not been made available to the public. FAS 86, paragraph 5, states:

Costs of producing product masters incurred subsequent to establishing technological feasibility shall be capitalized. Those costs include coding and testing performed subsequent to establishing technological feasibility. Software production costs for computer software that is to be used as an integral part of a product or process shall not be capitalized until both (a) technological feasibility of the product has been established for the software and (b) all research and development activities for the other components of the product or process have been completed.

15. FAS 86, paragraph 6, states:

Capitalization of computer software costs shall cease when the product is available for general release to customers. Costs of maintenance and customer support shall be charged to expense when related revenue is recognized or when those costs are incurred, whichever occurs first.

16. Paragraphs 8 through 11 of FAS 86 address the accounting and disclosure requirements for software costs capitalized under the provisions of paragraph 5 above.

17. FAS 7 states:

Generally accepted accounting principles that apply to established operating enterprises shall govern the recognition of revenue by a development stage enterprise and shall determine whether a cost incurred by a development stage enterprise is to be charged to expense when incurred or is to be capitalized or deferred. Accordingly, capitalization or deferral of costs shall be subject to the same assessment of recoverability that would be applicable in an established operating enterprise.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- FASB Statement No. 2, Accounting for Research and Development Costs
- FASB Statement No. 7, Accounting and Reporting by Development Stage Enterprises
- FASB Statement No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed
- FASB Interpretation No. 6, Applicability of FASB Statement No. 2 to Computer Software

State Regulations
- Maryland Insurance Statutes - Insurance Laws, Article 48A--Insurance Code, Subtitle 5, Assets and Liabilities
- New York Statutes - Insurance laws, Chapter 28 of the Consolidated Insurance Laws, Article 13, Assets and Deposits
Statutory Issue Paper No. 19
Furniture, Fixtures and Equipment

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The current statutory accounting guidance allows reporting entities to record furniture and equipment as assets, depreciate those assets, and nonadmit the undepreciated balance in the statutory financial statements. Alternatively, reporting entities may expense furniture and equipment when purchased. Guidance found in state statutes varies widely on the treatment of furniture, fixtures and equipment. GAAP requires purchases of furniture, fixture and equipment to be capitalized and depreciated over the expected useful lives of the assets. This issue paper establishes a framework for the accounting and reporting of furniture and equipment that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Furniture, fixtures and equipment generally meet the definition of assets established in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Within that definition, such items also meet the criteria defining nonadmitted assets. As such, the undepreciated portion of these assets shall be reported as nonadmitted assets and charged against surplus. These nonadmitted assets shall be depreciated against net income as the estimated economic benefit expires. This conclusion is a change from current statutory guidance because an acquisition which meets the definition of an asset established in Issue Paper No. 4 may no longer be expensed. This change will promote uniformity in the accounting for furniture, fixtures and equipment.

3. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

DISCUSSION

4. Issue Paper No. 4 defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Issue Paper No. 4 also states that an asset not readily available to satisfy policyholder obligations “shall be recorded as a nonadmitted asset and charged against surplus.” This is consistent with the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” Furniture, fixtures and equipment meet the definition of an asset but are not considered readily available to satisfy policyholder obligations. Therefore, it is in conformity with the above guidance to nonadmit these assets. This is also consistent with the concept of conservatism included in the Statement of Concepts.

Drafting Notes/Comments
- EDP equipment is addressed in Issue Paper No. 16 - Electronic Data Processing Equipment and Software
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
5. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Chapter 9, Nonadmitted Assets, in both manuals) require the nonadmission of furniture and equipment via one of two accounting methods:

1. The reporting entity may record furniture and equipment as an asset, depreciate it through the Summary of Operations and record the change in the nonadmitted amount through Exhibit 14 for Life and Accident and Health Insurance Companies or Exhibit 2 for Property and Casualty Insurance Companies, which directly affects surplus.

2. The reporting entity may expense furniture and equipment when purchased.

6. Guidance found in state statutes is not consistent on this issue. Some states allow the undepreciated balances of furniture and equipment over a specified cost threshold to be treated as admitted assets, in amounts up to stipulated percentages of the aggregate of all other assets. The threshold for capitalization and the percentage of admitted asset limits permitted vary widely. An example is the Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3, Life, Health and Accident Insurance, subchapter A. Terms Defined; Domestic Companies, which allows furniture, fixtures and equipment, including a data processing system, used in connection with the business of an insurance company to be admitted if the total value of the property exceeds $2,000 and constitutes less than 10% of the aggregate other admitted assets of the company. Assets which do not meet the threshold for capitalization (i.e., supplies) are expensed when purchased. Other states place no capitalization threshold on furniture, fixtures and equipment but require the assets to be amortized over a period not to exceed a specified number of years. For example, Florida Administrative Code, Title 38, Chapter 38F-5, Self-Insurers Funds, allows all furniture, fixtures and equipment of self insurers to be admitted as long as the assets are depreciated over a five-year useful life. Some states waive both the threshold for capitalization and the useful life requirement and only place limits on the percentage of admitted assets that the undepreciated balance of furniture, fixtures and equipment may comprise. An example is the Idaho statutes, Insurance Laws, Title 41, Insurance, Chapter 6, Assets and Liabilities, which states, “All office equipment, office furniture, private passenger automobiles, deemed necessary for conduct of insurance business, the aggregate amount of which shall not at any one time exceed one percent (1%) of the other assets of the insurer.”

Generally Accepted Accounting Principles
7. GAAP requires purchases of furniture, fixtures and equipment to be capitalized at their historical cost and depreciated over the expected useful life of the assets by recording a monthly charge against current income, in accordance with Accounting Research Bulletin No. 43, Restatement on Revision of Accounting Research Bulletins, Chapter 9, Depreciation. This treatment is consistent with the matching concept of GAAP, which requires revenues and expenses to be recognized in income over the period in which they are earned or incurred. Furniture, fixtures and equipment are reported in the balance sheet at their historical cost net of accumulated depreciation.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9, Nonadmitted Assets
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, Nonadmitted Assets
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
Generally Accepted Accounting Principles
- Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins, Chapter 9, Depreciation*

State Regulations
- Texas Statutes - Insurance Laws, Texas Insurance Code, Chapter 3, *Life, Health and Accident Insurance*, subchapter A. Terms Defined; Domestic Companies
- Texas Administrative Code, Title 28, Part I, Chapter 7, *Corporate and Financial*
- Florida Administrative Code, Title 38, Chapter 38F-5, *Self-Insurers Funds*
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Statutory Issue Paper No. 20
Gain Contingencies

STATUS
Finalized March 16, 1998

Type of Issue:
Common area

SUMMARY OF ISSUE

1. Current statutory guidance does not address accounting for gain contingencies. GAAP requires contingencies that may result in gains to be disclosed but not recorded in current year income.

2. This issue paper establishes the statutory accounting for gain contingencies that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of applying this statutory accounting principle, a “gain” shall be defined as an increase in surplus (net assets) which results from peripheral or incidental transactions of a reporting entity and from all other transactions and other events and circumstances affecting the reporting entity except those that result from revenues or investments by owners. If, on or before the balance sheet date, (a) the transaction or event has been fully completed, and (b) the amount of the gain is determinable, then the transaction or event is considered a gain, and is recognized in the financial statements. This definition excludes increases in surplus that result from activities that constitute a reporting entity’s ongoing major or central operations or activities. Because investment activities are central to an insurer’s operations, increases in surplus that result from such investment activities are excluded from the definition of gains. Revenues are inflows or other enhancements of assets of a reporting entity or settlements of its liabilities (or a combination of both) from providing products, rendering services, or other activities that constitute the reporting entity’s ongoing major or central operations. Investments by owners include any type of capital infused into the surplus of the reporting entity.

4. A “gain contingency” shall be defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible “gain” (as defined in the preceding paragraph) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur (e.g., a plaintiff has filed suit for damages associated with an event occurring prior to the balance sheet, but the outcome of the suit is not known as of the balance sheet date). Gain contingencies shall not be recognized in a reporting entity’s financial statements. However, if subsequent to the balance sheet date but prior to the issuance of the financial statements, the gain contingency is realized, the gain shall be disclosed in the notes to financial statements and the unissued financial statements should not be adjusted to record the gain. A gain is generally considered realizable when noncash resources or rights are readily convertible to known amounts of cash or claims to cash.

5. Gain contingencies shall not be recorded in a reporting entity’s financial statements. The notes to the financial statements shall contain adequate disclosure about the nature of the gain contingency. However, care should be exercised to avoid misleading implications as to the likelihood of realization.

DISCUSSION

6. This issue paper adopts paragraph 17 of FASB Statement No. 5, Accounting for Contingencies (FAS 5), which provides guidance with respect to the accounting and reporting of gain contingencies.
7. The definition of a “gain”, as stated in paragraph 3 above, is consistent with that of FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6). This definition of gains excludes investment activities of insurance companies.

8. Disclosure in a note to the financial statements but not recording a gain contingency is consistent with the conservatism and recognition concepts included in the Statement of Concepts. In addition, it prevents the recognition of transactions before the earnings process is completed (as prescribed in the recognition concept in the Statement of Concepts).

**Drafting Notes/Comments**
- Accounting for loss contingencies is addressed in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Revenue recognition issues are addressed in separate issue papers
- Income taxes are addressed in a separate issue paper
- Reinsurance agreements are addressed in a separate issue paper

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**
9. As noted above, current statutory guidance does not address gain contingencies. However, the conservatism and recognition concepts of the Statement of Concepts provide guidance which can be applied to the accounting treatment of gain contingencies. The conservatism concept of the Statement of Concepts states the following:

To the extent that factors or events result in adverse variation from management’s accounting estimates, the ability to meet policyholder obligations may be lessened. In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting. Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.

10. The recognition concept of the Statement of Concepts states that “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.”

**Generally Accepted Accounting Principles**
11. FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON 6), paragraphs 78 and 82, defines revenues and gains as follows:

Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners.

12. Additionally, paragraph 88 states the following:

Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be losses for another. For example, investments in securities that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies.

13. GAAP literature addresses accounting for gain contingencies in both general terms and in the event of gain contingencies which result from specific accounting treatments required by GAAP. FAS 5
provides general guidance for the treatment of gain contingencies. FAS 5, paragraph 17, states the following:

Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.

Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

14. Examples of GAAP literature which require a conservative treatment of gain recognition in specific accounting situations include:

1. FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, paragraph 14, which requires gains due to the curtailment of all or a portion of a defined benefit pension plan to be recognized in income only when the related employee terminations occur, as opposed to curtailment losses which must be recognized in income when it is probable that the curtailment will occur and the effects are reasonably estimable.

2. Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, paragraph 15, which requires gains from the disposal of a segment of a business to be recognized in income at the actual disposal date, as opposed to losses from the disposal of a segment of a business which must be recognized in income at the measurement date (i.e. the date at which management commits to a formal plan to dispose the segment).

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy

Generally Accepted Accounting Principles
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
- FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements
- Accounting Principles Board Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 21
Bills Receivable For Premiums

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Bills receivable, which are generally interest bearing, are used by reporting entities as methods of financing premiums. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides guidance on the accounting for bills receivable taken for premiums. However, the guidance for bills receivable in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies relates to non-premium loans (which will be addressed in a separate issue paper). This issue paper establishes statutory accounting for bills receivable for premiums that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Bills receivable for premiums meet the definition of assets as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. First, an evaluation shall be made to determine nonadmitted amounts. Next, an evaluation shall be made of such assets in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) to determine whether there is an impairment. This two step process is set forth below:

1. Bills receivable shall be accounted for as a nonadmitted asset if either of the following conditions are present:
   a. Past due installment: If any installment is past due, the entire bills receivable balance from that policy is nonadmitted; or
   b. Aggregate bills receivable balance due in excess of the unearned premium on the policy for which the note was accepted: If the aggregate bills receivable balance due exceeds the policy's unearned premium, the amount in excess of the unearned premium is nonadmitted.

3. Amounts determined to be uncollectible shall be written off: If, in accordance with Issue Paper No. 5, it is probable a portion of the bills receivable is uncollectible, any uncollectible bills receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

4. The following shall provide additional guidance in determining the nonadmitted portion of bills receivable:
   a. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements - Such amounts shall not be used to decrease the nonadmitted asset otherwise calculated.
   b. Determination of the Due Date - The due date is governed by the contractual due date of the installment.
DISCUSSION

5. The Statement of Concepts states:

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

6. Based upon the above concept, bills receivable should reflect only amounts that are available to meet both current and future policyholder obligations when the obligations are due. Therefore, amounts determined to be impaired (i.e., uncollectible), regardless of aging, should be charged to operations in the period such determination is made.

7. Under the conservatism concept of statutory accounting and consistent with current statutory accounting guidance, the entire bill receivable is nonadmitted if the related premium installment is past due. In addition, any excess of the aggregate bill receivable over the unearned premium amount on the policy of any performing bill receivable is nonadmitted. In accordance with the concept of conservatism, subsequent collection of nonadmitted assets should not be considered in the determining period-end nonadmitted assets. These recoveries should be accounted for in the period received.

Drafting Notes/Comments
- Accounting/aging of retrospective premiums currently reported on line 9.2 or line 9.3 is addressed in a separate issue paper.
- Accounting for uncollected agents’ balances is addressed in Issue Paper No 6. - Amounts Due From Agents and Brokers.
- A separate issue paper addresses unearned and unbilled premiums.
- Accounting for uncollected premium balances is addressed in Issue Paper No. 10 - Uncollected Premium Balances.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. Chapter 8, Other Admitted Assets, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies discusses bills receivable as follows:

(g) Bills receivable taken for premiums are admitted assets provided that the current installment is not past due, and the balance due does not exceed the unearned premium on the policy for which the note was accepted.

9. Chapter 9, Nonadmitted Assets, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies discusses bills receivable as follows:

6. Bills Receivable, Taken for Premiums: Bills or notes receivable are used as methods of financing premiums usually in states where installment premiums are not permitted or customary. If any portion of a bill or note receivable is unpaid past the due date of an installment, the entire bill or note is classified as nonadmitted. Also, on bills or notes not past due, the excess of the balance due over the unearned premium on the underlying policy or policies is classified as a nonadmitted asset. To the extent bills receivable are taken for premium for retrospectively rated policies, such bills must meet the same criteria required of accrued retrospective premiums to be reported as an admitted asset.
Generally Accepted Accounting Principles

10. GAAP addresses collectibility issues related to bills receivable in FASB Statement No. 5, Accounting for Contingencies (FAS 5), paragraphs 1, 3 and 8:

1. For the purpose of this Statement (FAS 5), a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a "gain contingency") or loss1 (hereinafter a "loss contingency") to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

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1 The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

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3. When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

a) Probable. The future event or events are likely to occur.

b) Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

c) Remote. The chance of the future event or events occurring is slight.

8. An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income3 if both of the following conditions are met:

a) Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.4 It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b) The amount of loss can be reasonably estimated.

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3 Paragraphs 23-24 of APB Opinion No. 9, Reporting the Results of Operations, describe the rare circumstances in which a prior period adjustment is appropriate. Those paragraphs are not amended by this Statement.

4 Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented.

11. The FAS 5 criteria above is used in interpreting information such as historical trending and general information about the financial condition of the insureds in an effort to evaluate the collectibility of a receivable balance. Accounting for contingencies is discussed in more detail in Issue Paper No. 5.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 8 and 9
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

**Generally Accepted Accounting Principles**
- FASB Statement No. 5, *Accounting for Contingencies*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 22
Leases

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance provides only limited guidance on the accounting for leases and does not clearly differentiate capital and financing leases from operating leases. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies state that the form of lease agreements should determine the accounting. However, the manuals also state that lease-purchase transactions should be accounted for in accordance with their substance. Both sections state that GAAP is commonly used as a guideline where not in conflict with statutory accounting principles. This guidance generally has been interpreted to prescribe operating lease treatment for all leases, but to allow sales-type lease treatment by lessors if the criteria established in GAAP are met.

2. The purpose of this issue paper is to establish statutory accounting principles for leases by lessors and lessees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting and reporting by lessees
- Accounting and reporting by lessors
- Sale-leaseback transactions
- Leveraged leases for lessors
- Related party leases
- Disclosures

SUMMARY CONCLUSION

3. For purposes of statutory accounting principles, a lease is defined as an agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time. This definition does not include agreements that are contracts for services that do not transfer the right to use property, plant, or equipment from one contracting party to the other (i.e., employee lease contracts). On the other hand, agreements that do transfer the right to use property, plant, or equipment meet the definition of a lease for purposes of statutory accounting principles even though substantial services by the contractor (lessor) may be called for in connection with the operation or maintenance of such assets.

Accounting and Reporting by Lessees

4. All leases shall be considered operating leases. Rent on an operating lease shall be charged to expense over the lease term as it becomes payable, except as provided in paragraphs 5 and 6.

5. As discussed in FASB Technical Bulletin 85-3, Accounting for Operating Leases with Scheduled Rent Increases, the effects of scheduled rent increases normally shall be recognized on a straight-line basis over the lease term.

6. Lease agreements may also include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee’s preexisting lease. As discussed in FASB Technical Bulletin 88-1, Issues
Relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease; Lease Incentives in an Operating Lease; Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor; Money-Over-Money Lease Transactions; Wrap Lease Transactions, incentives paid to or payments made on behalf of the lessee shall be considered reductions of minimum lease payments (i.e., the payments that the lessee is obligated to make or can be required to make in connection with the leased properties.) These incentives shall be recognized over the lease term on a straight-line basis unless the use of another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. (The lessee’s immediate recognition of expenses or losses (e.g., moving costs, losses on subleases, write-offs of leasehold improvements) shall not be changed by this guidance.)

Accounting and Reporting by Lessors

7. All leases, except leveraged leases as defined in paragraph 14, shall be considered operating leases and accounted for by the lessor as follows:

a. The leased property shall be included in the same balance sheet category it would be had the property not been leased. The property shall be depreciated following the lessor's normal depreciation policies for such assets.

b. Rental income shall be reported as investment income as it becomes receivable according to the provisions of the lease. However, as discussed in paragraphs 5 and 6 of this issue paper, rentals may be recognized before they become due, if rentals vary from the straight-line basis. The guidance in Issue Paper No. 34 - Investment Income Due and Accrued shall be applied to the receivable balance.

c. Initial direct costs shall be charged to expense when incurred, and shall not be deferred and allocated over the lease term. Initial direct costs are those incremental costs that the lessor has incurred in directly evaluating, negotiating, administering, and closing a lease transaction.

8. The sale of property subject to an operating lease, or of property that is leased by or intended to be leased by the third-party purchaser to another party, shall not be treated as a sale if the seller or any party related to the seller (related party is defined in Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties, (Issue Paper No. 25)) retains substantial risks of ownership in the leased property.

Sale-Leaseback Transactions

9. Sale-leaseback transactions involve the sale of property, plant, or equipment by the owner and a lease of the asset back to the seller. Sale-leaseback accounting, whereby the seller-lessee records the sale, removes the assets and related liabilities from its balance sheet, and accounts for the lease in accordance with the guidance in paragraphs 4-6 of this issue paper, shall be used by the seller-lessee for sale-leaseback transactions only if the transaction includes all of the following:

a. A normal leaseback (see paragraph 11)

b. Payment terms and provisions that adequately demonstrate the buyer-lessee's initial and continuing investment in the property (see paragraph 12)

c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee (see paragraph 12)

d. Admitted assets, if the buyer-lessee is a related party, or either admitted or nonadmitted assets if the buyer-lessee is not a related party. For purposes of this paragraph, related
Leases

parties include those identified in Issue Paper No. 25 and entities created for the purpose of buying and leasing nonadmitted assets for the reporting entity and/or its affiliates.

When applying sale-leaseback accounting, the sale, and gains or losses thereon, shall be recognized in accordance with the relevant statutory guidance for the asset being sold. For example, sales of real estate shall be accounted for in accordance with Issue Paper No. 40 - Real Estate Investments (Issue Paper No. 40), which adopts FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66).

10. If criteria a., b., or c. in paragraph 9 are not met the sale of the asset shall be accounted for as a financing or deposit in accordance with FAS 66, which was adopted in Issue Paper No. 40. If criteria 9 d. is not met, the deposit method shall be used. Under the deposit method, the seller recognizes no profit or loss on the sale, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer. Lease payments decrease and collections on the buyer-lesser’s note, if any, increase the seller-lessee’s deposit account. The property and related debt continue to be in the seller-lessee’s balance sheet, and the seller-lessee continues to depreciate the property. Also, a loss shall be recognized by the seller-lessee, if, at any reporting date, the net admitted value of the leased asset exceeds the sum of the balance in the deposit account, the fair value of the unrecorded note receivable, and any debt assumed by the buyer. Under the financing method, the asset will continue to be carried as an admitted asset. The proceeds from the sale are recognized as a borrowing (liability) and equated to the present value of the leaseback rents to determine the interest rate to use to accrue interest on the debt. If there is a change in lease terms such that the sale-leaseback transaction subsequently qualifies for sale-leaseback accounting recognition, sale-leaseback accounting as described in paragraph 9 shall be applied as if the sale had been recognized at the inception of the lease. Otherwise at the end of the lease term any deferred profit shall be recognized.

11. A normal leaseback in the context of a real estate sale-leaseback shall be defined as a lessee-lessee relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions.

12. A continuing involvement provision shall be defined as involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessee. Examples of continuing involvement are as follows:

a. The seller-lessee has an obligation or an option to repurchase the property or the buyer-lessee can compel the seller-lessee to repurchase the property.

b. The seller-lessee guarantees the buyer-lessee’s investment or a return on that investment for a limited or extended period of time.

c. The seller-lessee is required to pay the buyer-lessee at the end of the lease term for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.

d. The seller-lessee provides nonrecourse financing to the buyer-lessee for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.

e. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

f. The seller-lessee provides collateral on behalf of the buyer-lessee other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to
the seller-lessee guarantees the buyer-lessee's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessee's investment.

g. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessee.

h. The buyer-lessee is obligated to share with the seller-lessee any portion of the appreciation of the property.

13. The buyer-lessee shall account for the purchase in accordance with applicable statutory guidance for the asset acquired and lease in accordance with paragraphs 7-8 of this issue paper.

Leveraged Leases for Lessors

14. Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially “leveraged” in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Leveraged leases shall be defined as those leases that meet the criteria set forth in paragraph 42 a-d (and the related paragraphs to which 42 refers) of FASB Statement No. 13, Accounting for Leases (FAS 13) as amended and interpreted. Leases which meet the preceding definition shall be accounted for in accordance with paragraphs 43-47 (and the related paragraphs to which 43-47 refer) of FAS 13. The lessor shall record its investment net of the nonrecourse debt. In cases where the asset being leased is a nonadmitted asset, any net leveraged lease asset shall be nonadmitted.

Related-Party Leases

15. This issue paper applies to arms-length transactions. To the extent that leases between related parties are, in substance, arms-length transactions the guidance in this issue paper shall be applied. The determination of whether related party leases qualify as arms length transactions will be addressed in Issue Paper No. 25.

Disclosures

16. The following disclosures shall be made in the notes to the financial statements of lessees:

- A general description of the lessee’s leasing arrangements including, but not limited to, the following:

  (1) Rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

  (2) The basis on which contingent rental payments are determined.

  (3) The existence and terms of renewal or purchase options and escalation clauses.

  (4) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing.

- Additionally, for leases having initial or remaining noncancelable lease terms in excess of one year:

  (1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

  (2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.
- For sale-leaseback transactions:

(1) A description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

(2) For those accounted for as deposits, (a) the obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years and (b) the total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding years.

When leasing is a significant part of the lessee's business activities in terms of revenue, net income, or assets, the following information with respect to leases shall be disclosed in the financial statements:

- For operating leases:

(1) The cost and carrying amount, if different, of property on lease or held for leasing by major classes of property according to nature or function, and the amount of accumulated depreciation in total as of the date of the latest balance sheet presented;

(2) Minimum future rentals on noncancelable leases as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding years;

(3) Total contingent rentals included in income for each period for which an income statement is presented; and

(4) A general description of the lessor’s leasing arrangements.

- For leveraged leases:

(1) A description of the terms including the pretax income from the leveraged leases shall be disclosed in the notes to the financial statements. For purposes of presenting the investment in a leveraged lease in the lessor's balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment).

(2) In the notes to the financial statements, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period.

(3) When leveraged leasing is a significant part of the lessor's business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases shall be disclosed in the notes to the financial statements.

DISCUSSION

17. This issue paper provides more comprehensive guidance on accounting for leases than exists in the current statutory accounting literature. Nevertheless, the principles established are generally consistent with current statutory accounting principles.

18. This issue paper rejects FAS 13, as amended and interpreted, except for certain of the guidance on operating leases, sale-leaseback transactions and leveraged leases (i.e., paragraphs 15, 16(b, c, d), 19(a, b), 23(b, c), 36, 37, 38(b), 39(c) and, 42-47). A complete list of all FASB Statements, Interpretations and Technical Bulletins adopted and rejected by this issue paper is included in the Relevant GAAP Literature.
section of this paper. FAS 13 was rejected because this issue paper provides that all leases except for leveraged leases, are accounted for as operating leases, whereas the essence of FAS 13 is to classify and account for leases as either capital or operating.

19. The statutory accounting principles differ from GAAP as follows:

- All leases except for leveraged leases for lessors are accounted for as operating leases. Under GAAP, leases are treated as operating or capital by lessees and as operating, sales-type, direct financing or leveraged leases by lessors.

- No distinction is made between current and long term classifications on the balance sheet.

- Sale-leaseback transactions involving related parties and nonadmitted assets are accounted for by the seller-lessee as deposits.

20. In rejecting the FAS 13 guidance on capital and financing leases for all leases other than leveraged leases, the financial statement impact of classification and accounting for the different types of leases under GAAP was considered and is explained and described below for both lessees and lessors:

Lessee

Capital lease - A capital lease is reflected on the lessee’s balance sheet as both an asset and a corresponding liability. A capital lease generally produces a declining income statement charge over the term of the lease, represented by the sum of amortization of the capitalized asset, usually straight-line, and a declining interest expense element on the lease obligation balance. The effect is similar to that which would result if the lessee borrowed money and purchased the asset outright instead of leasing it.

Operating lease - An operating lease does not result in an asset or liability being reflected on the lessee's balance sheet. An operating lease normally results in a level income statement charge over the term of the lease reflecting the rent payments required by the lease agreement.

Lessor

Direct financing lease - A direct financing lease is treated as in effect a loan, producing declining revenue similar to interest over the term of the lease. Under the accelerated pattern of revenue recognition provided by a direct financing lease, revenue declines relative to the lessor's declining investment and thus matches the pattern of the lessor's interest carrying costs, either explicit or implicit. The balance sheet effect of the accounting for a direct financing lease is that the lessor's asset is effectively converted from a property classification to a receivable (net investment in the lease).

Sales-type lease - In addition to the effects of the direct financing lease described above, in a sales-type lease the manufacturer or dealer records a sale and the related cost of sales and gross profit at the beginning of the lease. In the balance sheet the treatment converts leased property carried at manufacturing or wholesale cost to a receivable equal to the normal selling price (i.e., the price the asset would sell for in an arms-length transaction).

Leveraged Leases - Generally, leveraged leases are those in which the lessor acquires, through the incurrence of debt (such that the lessor is substantially "leveraged" in the transaction), property, plant or equipment with the intentions to lease the asset(s) to the lessee. Except for the exclusion of leveraged leases from the definition of a direct financing leases, it otherwise meets the definition of a direct financing lease. A leveraged lease involves at least three parties: the lessee, a long-term creditor, and a lessor. The long-term creditor provides financing, which is a significant
percentage of the cost of the property, to the lessor which is nonrecourse as to the general credit of the lessor. The lessor’s investment in the property declines after the original investment has been made, often turns negative, and then increases during later years of the lease before it finally is realized. The lessor records the investment in a leveraged lease net of the nonrecourse debt. Income is recognized only in periods in which the net investment is positive.

Operating lease - An operating lease generally produces a level income effect over the term of the lease, represented by the excess of the level rent payments called for by the lease agreement over straight-line depreciation of the leased asset. (This level income from the lease would compare to a generally declining pattern of either explicit or implicit interest carrying costs.) Depreciable life would extend beyond the initial lease term. The rental income and depreciation are shown broad in the income statement as revenue and expense, respectively. For balance sheet purposes, the leased asset is classified with or near property, plant and equipment.

21. Since (a) statutory accounting principles provide for offsetting of obligations against real estate assets, (b) certain assets would be considered nonadmitted assets if capitalized, (c) most leases are considered operating leases under GAAP and (d) leasing is not a significant part of insurance companies business the objectives of statutory accounting would not be appreciably enhanced by adopting the GAAP guidance.

22. In addition, the statutory accounting principles established in this issue paper provide for the deferral of any gains on sales of property with a leaseback, except if certain strict criteria are met. Such accounting meets the conservatism objective in the Statement of Concepts. Furthermore, the statutory accounting principles established for sale-leaseback transactions of nonadmitted assets with related parties meet the conservatism objective by eliminating the possibility of surplus enhancement through sale-leaseback transactions involving nonadmitted assets.

Drafting Notes/Comments
- Accounting for real estate, including sales of real estate, is addressed in Issue Paper No. 40 - Real Estate Investments.
- Accounting for related party transactions is addressed in Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.
- Issue Paper No. 34 - Investment Income Due and Accrued allows investment income not yet due to be considered an admitted asset. Under this issue paper rental income may be recognized before it is due.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
23. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for leases as follows:

Investments in Real Estate, Equipment and Other Assets Involving Leases

The statutory method of accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. Life insurance companies are encouraged to account for lease purchase transactions with the same objectives in mind as in accounting for all transactions, conservatism and policyholder protection. Financial Accounting Standards Board Statements 13, 28, and 66 are commonly used as guidelines where not in conflict with statutory accounting principles.

24. The accounting treatment as stated in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies is similar to the treatment stated in the preceding paragraph.
25. In the August 5, 1987 meeting of the Emerging Accounting Issues Working Group, a consensus was reached as to the accounting for free rent. The minutes read as follows:

**Accounting for Free Rent**

The recent soft real estate market has given rise to the unusual situation of new tenants receiving “free rent” during initial periods of tenancy. An insurer requested direction as to the appropriate statutory accounting treatment during the term of the lease.

Two alternatives were considered by the working group:

1. A “cash basis” method reflecting no payments during the “free rent” period and then accounting for the monthly rentals as payments are made.

2. A method based on GAAP treatment which would require the spreading of the actual rent to be paid over the full lease period. The “free rent” period would reflect monthly rent expense on an accrual basis. The accrued rent liability would increase during the “free rent” period and be reduced monthly with the cash payment of rent after the initial period.

The working group concluded that the second method was preferable.

26. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of home office buildings in their May 7, 1986 meeting. The minutes are as follows:

**Sale and Leaseback of Home Office Buildings**

The third area of discussion was the sale and leaseback of home office buildings where notes are taken back as part of the purchase price and the result is an increase to the insurer’s surplus through recognition of gain on the sale.

The issues discussed and the consensus reached were:

1. Should FASB 66 be applicable for statutory purposes?

2. Is there a need for special statutory accounting direction or should each situation be treated individually?

Present statutory accounting probably permits recognition of the gain. The group believes, however, that FASB 66 should be used for guidance by regulators, if not contrary to law, and, at a commissioners discretion.

27. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of a sale and leaseback of furniture and equipment in their September 11, 1989, meeting. The minutes are as follows:

**Accounting for Sale and Leaseback of Furniture and Equipment**

Mr. Robert Solitro, Director of Examinations for the State of New Hampshire Insurance Department, had requested that this item be placed on the agenda of the working group. His request included an issue summary (Attachment A).

In the situation described, an insurance company would enter into a sale and lease-back agreement with a third party, non-affiliate, in which nonadmitted furniture is sold and then leased-back. As described, the terms of the agreement would provide that future payments to be made by the insurance company would be equal to or greater than the proceeds to be received from the original sale.
The issue identified and addressed by the working group at this meeting was as follows:

Should the transaction be accounted for as an operating lease or a capital lease?

The working group reached the consensus that for sale and leaseback transactions involving furniture and non-EDP equipment guidance should be obtained from FASB No. 13 and related amendments. In a case where it is determined that the transaction results in a capital lease, no surplus enhancement should be recorded.

28. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the issue of capital gains and increased real estate valuation through sale-leaseback and repurchase transactions in their December 4, 1989, meeting. The minutes are as follows:

Capital Gains and Increased Real Estate Valuation Through Sale-Leaseback and Repurchase Transactions

This topic was raised by Hyrum Gentner, Chief Insurance Examiner of the Utah Insurance Department and John Kay, Senior Examiner in that department (Attachment G). The situation described involved the sale and lease-back of an insurer's real estate with the insurer accepting a note for most of the proceeds of the sale. The lease-back was for 12 months with an option for an additional 19 years. The insurer paid for an option to repurchase the property. A significant gain was realized on the sale. The insurer repurchased the property and used the repurchase cost plus the cost of the repurchase option to determine the book value of the real estate. The result was an increased valuation, slightly less than the realized capital gain on the sale.

Mr. Gentner and Mr. Kay had also indicated that the Utah Department had been faced with three alternatives: (1) to recognize the gain and increased asset valuation, (2) to not recognize the gain and increased asset valuation, and (3) to recognize both and make full disclosure including a comment expressing the Insurance Department concern regarding the nature of the transactions. In connection with the last option, regulations would then be implemented requiring prior written departmental approval for such transactions and specifying the Commissioners authority to establish investment valuation reserves.

After a general discussion of the subject, Norris Clark, chair of the working group was authorized to respond to the Utah Insurance Department stating that the issue had been discussed at the January 22, 1986 (86-1) and May 7, 1986 (86-3) meetings of the working group and that the transactions discussed by Mr. Gentner and Mr. Kay appeared to be of the kind in which no gain should be recognized.

Generally Accepted Accounting Principles

29. Accounting for leases is governed by FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins. Some key paragraphs of the FASB Current Text, Section L10, Leases, follow (note that the Current Text is an integration of currently effective accounting and reporting standards and that the authority of the Current Text is derived from the underlying pronouncements, which remain in force):

.102 For purposes of applying the accounting and reporting standards [herein], leases are classified as follows:

a. Classifications from the standpoint of the lessee:
   (1) Capital leases. Leases that meet one or more of the criteria in paragraph .103.
   (2) Operating leases. All other leases.

b. Classifications from the standpoint of the lessor: [FAS 13, ¶6]
   (1) Sales-type leases. Leases that give rise to manufacturer's or dealer's profit (or loss) to the lessor (that is, the fair value of the leased property at the inception of the lease is greater or less than its cost or carrying amount, if different) and that meet one or more of the criteria in paragraph .103 and both of the criteria in
paragraph .104, except as indicated in the following sentence. A lease involving
real estate shall be classified as a sales-type lease only if it meets the criterion in
paragraph .103(a), in which case the criteria in paragraph .104 do not apply. [FAS 98, ¶22c] Normally, sales-type leases will arise when manufacturers or
dealers use leasing as a means of marketing their products. Leases involving
lessors that are primarily engaged in financing operations normally will not be
sales-type leases if they qualify under paragraphs .103 and .104, but will most
often be direct financing leases, described in paragraph .102(b)(2) below. However, a lessor need not be a dealer to realize dealer's profit (or loss) on a
transaction, for example, if a lessor, not a dealer, leases an asset that at the
inception of the lease has a fair value that is greater or less than its cost or
carrying amount, if different, such a transaction is a sales-type lease, assuming
the criteria referred to are met. [FAS 13, ¶6] Leases of a manufacturing
company's equipment sold to a leasing subsidiary that are accounted for as
direct financing leases on the subsidiary's financial statements normally would be
sales-type capital leases in the consolidated financial statements. [FAS94, ¶52] A renewal or extension of an existing sales-type or direct financing lease that
otherwise qualifies as a sales-type lease shall be classified as a direct financing
lease unless the renewal or extension occurs at or near the end of the original
term 3 specified in the existing lease, in which case it shall be classified as a
sales-type lease (refer to paragraph .113(f)). [FAS27, ¶6]

(2) Direct financing leases. Leases other than leveraged leases that do not give rise
to manufacturer's or dealer's profit (or loss) to the lessor but that meet one or
more of the criteria in paragraph .103 and both of the criteria in paragraph .104.
In such leases, the cost or carrying amount, if different, and fair value of the
leased property are the same at the inception of the lease. [FAS13, ¶6] An
exception arises when an existing sales-type or direct financing lease is renewed
or extended during the term of the existing lease. [FAS27, ¶7] In such cases, the
fact that the carrying amount of the property at the end of the original lease term
is different from its fair value at that date shall not preclude the classification of
the renewal or extension as a direct financing lease (refer to paragraph .113(f)).

(3) Leveraged leases. Leases that meet the criteria of paragraph .144. [FAS13, ¶6]

(4) Operating leases. All other leases, including leases that involve real estate and
give rise to manufacturer's or dealer's profit (or loss) to the lessor but do not
meet the criterion in paragraph .103(a). [FAS98, ¶22d] Criteria for Classifying
Leases (Other Than Leveraged Leases)

.103 The criteria for classifying leases set forth in this paragraph and in paragraph .104 derive
from the concept [FAS 13, paragraph 7] that a lease that transfers substantially all of the benefits
and risks incident to the ownership of property should be accounted for as the acquisition of an
asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor.
All other leases should be accounted for as operating leases. In a lease that transfers
substantially all of the benefits and risks of ownership, the economic effect on the parties is
similar, in many respects, to that of an installment purchase. [FAS 13, paragraph 60] If at its
inception a lease meets one or more of the following four criteria, the lease shall be classified as
a capital lease by the lessee. Otherwise, it shall be classified as an operating lease. (Refer to
paragraph .150 and Exhibit 150C for an illustration of the application of these criteria.)

a. The lease transfers ownership of the property to the lessee by the end of the lease
term.4a

b. The lease contains a bargain purchase option.

c. The lease term is equal to 75 percent or more of the estimated economic life of the
leased property. However, if the beginning of the lease term falls within the last 25
percent of the total estimated economic life of the leased property, including earlier years
of use, this criterion shall not be used for purposes of classifying the lease.

d. The present value5 at the beginning of the lease term of the minimum lease payments,
excluding that portion of the payments representing executory costs, to be paid by the
lessor, including any profit thereon, equals or exceeds 90 percent of the excess of the fair
value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.\(^6\)

However, if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use, this criterion shall not be used for purposes of classifying the lease. A lessor shall compute the present value of the minimum lease payments using the interest rate implicit in the lease. A lessee shall compute the present value of the minimum lease payments using its incremental borrowing rate unless (1) it is practicable for him to learn the implicit rate computed by the lessor and (2) the implicit rate computed by the lessor is less than the lessee’s incremental borrowing rate. If both of those conditions are met, the lessee shall use the implicit rate. [FAS 13, paragraph 7]

\(^4\) This criterion is met in situations in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee, for example, the minimum required by statutory regulation to transfer title. [FAS 98, paragraph 22e]

\(^5\) Refer to paragraphs .509 through .511 for supplemental guidance on the interest rate to be used in calculating the present value of minimum lease payments.

\(^6\) The 90-percent test is stated as a lower limit rather than as a guideline. [FIN 19, paragraph 4]

.104 From the standpoint of the lessor, a lease involving real estate shall be classified as a sales-type lease only if it meets the criterion in paragraph .103(a) as appropriate under paragraph .102(b)(1). Otherwise, if the lease at inception meets any one of the four criteria in paragraph .103 and in addition meets both of the following criteria, it shall be classified as a sales-type lease, a direct financing lease, a leveraged lease, or an operating lease as appropriate under paragraph .102(b). If the lease does not meet any of the criteria of paragraph .103 or both of the following criteria, the lease shall be classified as an operating lease.

a. Collectibility of the minimum lease payments is reasonably predictable. A lessor shall not be precluded from classifying a lease as a sales-type lease, a direct financing lease, or a leveraged lease simply because the receivable is subject to an estimate of uncollectibility based on experience with groups of similar receivables. [FAS98, ¶22f]

b. No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.\(^7\) Important uncertainties might include commitments by the lessor to guarantee performance of the leased property in a manner more extensive than the typical product warranty or to effectively protect the lessee from obsolescence of the leased property. However, the necessity of estimating executory costs to be paid by the lessor (refer to paragraphs .113(a) and .114(a)) shall not by itself constitute an important uncertainty as referred to herein. [FAS13, ¶8]

\(^7\) If the property covered by the lease is yet to be constructed or has not been acquired by the lessor at the inception of the lease, the classification criteria of paragraph .104(b) shall be applied at the date that construction of the property is completed or the property is acquired by the lessor. [FAS23, ¶7]

.105 If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs .103 and .104 had the changed terms been in effect at the inception of the lease, the revised agreement shall be considered as a new agreement over its term, and the criteria in paragraphs .103 and .104 shall be applied for purposes of classifying the new lease. Likewise, except when a guarantee or penalty is rendered inoperative as described in paragraphs .108 and .113(e), any action that
extends the lease beyond the expiration of the existing lease term, such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement, which shall be classified according to the provisions of paragraphs .102 through .104. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property) or changes in circumstances (for example, default by the lessee), however, shall not give rise to a new classification of a lease for accounting purposes. [FAS13, ¶9]

Accounting and Reporting by Lessees

Operating Leases

.111 Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used. [FAS 13, paragraph 15]

.112 The following information with respect to leases shall be disclosed in the lessees financial statements or the footnotes thereto. (Refer to paragraphs .151 and .152 for illustrations.)

b. For operating leases having initial or remaining noncancelable lease terms in excess of one year:

(1) Future minimum rental payments required as of the date of the latest balance sheet presented, in the aggregate and for each of the five succeeding fiscal years.

(2) The total of minimum rentals to be received in the future under noncancelable subleases as of the date of the latest balance sheet presented.

c. For all operating leases, rental expense for each period for which an income statement is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals. Rental payments under leases with terms of a month or less that were not renewed need not be included.

d. A general description of the lessees leasing arrangements including, but not limited to, the following:

(1) The basis on which contingent rental payments are determined.

(2) The existence and terms of renewal or purchase options and escalation clauses.

(3) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt, and further leasing. [FAS 13, paragraph 16]

Sales-Type Leases

.113 Sales-type leases shall be accounted for by the lessor as follows:

a. The minimum lease payments (net of amounts, if any, included therein with respect to executory costs to be paid by the lessor, together with any profit thereon) plus the unguaranteed residual value accruing to the benefit of the lessor shall be recorded as the
Leases

The estimated residual value used to compute the unguaranteed residual value accruing to the benefit of the lessor shall not exceed the amount estimated at the inception of the lease. However, if the sales-type lease involves real estate, the lessor shall account for the transaction under the provisions of Section R10, “Real Estate,” in the same manner as a seller of the same property. [FAS23, ¶9]

13b Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payment.

14 If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of the paragraph. FAS23, ¶9

The difference between the gross investment in the lease in (a) above and the sum of the present values of the two components of the gross investment shall be recorded as unearned income. The discount rate to be used in determining the present values shall be the interest rate implicit in the lease. The net investment in the lease shall consist of the gross investment less the unearned income. The unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. [FAS13, ¶17] Contingent rentals shall be included in the determination of income as accrable. [FAS29, ¶13] [(Refer to paragraph .165 for an illustration involving contingent rentals.)]

This is the interest method described in Section 169, paragraph .108 and footnote 4. [FAS13, ¶12, fn 11]

The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs, less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

d. The estimated residual value shall be reviewed at least annually. If the review results in a lower estimate than had been previously established, a determination must be made as to whether the decline in estimated residual value is other than temporary. If the decline in estimated residual value is judged to be other than temporary, the accounting for the transaction shall be revised using the changed estimate. The resulting reduction in the net investment shall be recognized as a loss in the period in which the estimate is changed. An upward adjustment of the estimated residual value shall not be made.

This paragraphs .514 through .517 discuss upward adjustment of guaranteed residential values.

e. In leases containing a residual guarantee or a penalty for failure to renew the lease at the end of the lease term, following the method of amortization described in (b) above will
result in a balance of minimum lease payments receivable at the end of the lease term that will equal the amount of the guarantee or penalty at that date. In the event that a renewal or other extension of the lease term renders the guarantee or penalty inoperative, the existing balances of the minimum lease payments receivable and the estimated residual value shall be adjusted for the changes resulting from the revised agreement (subject to the limitation on the residual value imposed by subparagraph (d) above) and the net adjustment shall be charged or credited to unearned income. [FAS13, ¶17]

17 Residual guarantees and termination penalties that serve to extend the lease term are excluded from minimum lease payments and are thus distinguished from those guarantees and penalties referred to in this paragraph. [FAS13, ¶17 fn 17]

f. Except for a change in the provisions of a lease that results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee by a change in the provisions of the lease agreement and the revised agreement is classified as a direct financing lease (refer to paragraph .110), a change in the provisions of a lease, a renewal or extension of an existing lease, and a termination of a lease prior to the expiration of the lease term shall be accounted for as follows: [FAS22, ¶15]

(1) If the provisions of a lease are changed in a way that changes the amount of the remaining minimum lease payments and the change either (a) does not give rise to a new agreement under the provisions of paragraph .105 or (b) does give rise to a new agreement but such agreement is classified as a direct financing lease, the balance of the minimum lease payments receivable and the estimated residual value, if affected, shall be adjusted to reflect the change (subject to the limitation on the residual value imposed by subparagraph (d) above), and the net adjustment shall be charged or credited to unearned income. If the change in the lease provisions gives rise to a new agreement classified as an operating lease, the remaining net investment shall be removed from the accounts, the leased asset shall be recorded as an asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. The new lease shall thereafter be accounted for as any other operating lease.

(2) Except when a guarantee or penalty is rendered inoperative as described in subparagraph (e) above, a renewal or an extension of an existing lease shall be accounted for as follows:

(a) If the renewal or extension is classified as a direct financing lease, it shall be accounted for as described in subparagraph (f)(1) above.

(b) If the renewal or extension is classified as an operating lease, the existing lease shall continue to be accounted for as a sales-type lease to the end of its original term, and the renewal or extension shall be accounted for as any other operating lease. [FAS13, ¶17]

(c) If a renewal or extension that occurs at or near the end of the term of the existing lease is classified as a sales-type lease, the renewal or extension shall be accounted for as a sales-type lease. [FAS27, ¶8]

18 A renewal or extension that occurs in the last few months of an existing lease is considered to have occurred at or near the end of the existing lease term. [FAS27, ¶8]
(3) A termination of the lease shall be accounted for by removing the net investment from the accounts, recording the leased asset at the lower of its original cost, present fair value, or present carrying amount, and the net adjustment shall be charged to income of the period. [FAS13, ¶17]

g. If prior to the expiration of the lease term a change in the provisions of a lease results from a refunding by the lessor of tax-exempt debt, including an advance refunding, in which the perceived economic advantages of the refunding are passed through to the lessee and the revised agreement is classified as a direct financing lease by the lessor, the change shall be accounted for as follows:

1. If a change in the provisions of a lease results from a refunding of tax-exempt debt, including an advance refunding that is accounted for as an early extinguishment of debt, the lessor shall adjust the balance of the minimum lease payments receivable and the estimated residual value, if affected (that is, the gross investment in the lease), in accordance with the requirements of paragraphs .114(c) and .113(f)(1). The adjustment of unearned income shall be the amount required to adjust the net investment in the lease to the sum of the present values of the two components of the gross investment based on the interest rate applicable to the revised lease agreement. The combined adjustment resulting from applying the two preceding sentences shall be recognized as a gain or loss in the current period. [Paragraphs .162 and .163 illustrate the accounting prescribed by this paragraph.]

2. If a change in the provisions of the lease results from an advance refunding that is not accounted for as an early extinguishment of debt at the date of the advance refunding, the lessor shall systematically recognize, as revenue, any reimbursements to be received from the lessee for costs related to the debt to be refunded, such as unamortized discount or issue costs or a call premium, over the period from the date of the advance refunding to the call date of debt to be refunded. [FAS22, ¶12]

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19 An advance refunding involves the issuance of new debt to replace existing debt with the proceeds from the new debt placed in trust or otherwise restricted to retire the existing debt at a determinable future date or dates. [FAS22, ¶1, fn1] Section D 14, “Debt: Extinguishments,” provides criteria for determining whether the advance refunding should be recognized as an extinguishment of the existing debt at the date of the advance refunding. FAS76, ¶10

20 This paragraph prescribes the accounting for a direct financing lease by governmental units that classify and account for leases of that kind [FAS22, ¶12, fn4]

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Accounting and Reporting by Lessors

Operating Leases

.115. Operating leases shall be accounted for by the lessor as follows:

a. The leased property shall be included with or near property, plant, and equipment in the balance sheet. The property shall be depreciated following the lessor's normal depreciation policy, and in the balance sheet the accumulated depreciation shall be deducted from the investment in the leased property.

b. Rent shall be reported as income over the lease term as it becomes receivable according to the provisions of the lease. However, if the rentals vary from a straight-line basis, the income shall be recognized on a straight-line basis unless another systematic and
rational basis is more representative of the time pattern in which use benefit from the leased property is diminished, in which case that basis shall be used.

24a Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

c. Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence. [FAS 13, paragraph 19]

d. If, at the inception of the lease, the fair value of the property in an operating lease that would have been classified as a sales-type lease except that it did not meet the criterion in paragraph .103(a) is less than its cost or carrying amount, if different, then a loss equal to that difference shall be recognized at the inception of the lease. [FAS 98, paragraph 22]

Sale-Leaseback Transactions

Sale-leaseback transactions involve the sale of property by the owner and a lease of the property back to the seller. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the seller-lessee in accordance with the provisions of paragraph .129 [except that a sale-leaseback involving real estate, property improvements, or integral equipment27a shall be accounted for in accordance with the provisions of paragraphs .130A through .130M]. A sale of property that is accompanied by a leaseback of all or any part of the property for all or part of its remaining economic life shall be accounted for by the [buyer-lessee] in accordance with the provisions of paragraph .130. [FAS28, paragraph 2] [See paragraphs .544 through .545 for supplemental guidance in accounting for sale-leaseback transactions when nonrecourse debt is obtained using the lease rentals or lease rentals and the leased asset as collateral and the nonrecourse debt is sold with the asset to a third party investor (a wrap lease transaction).]

27a The terms property improvements and integral equipment are discussed in paragraph .130A and footnote 32a.

.129 If the lease meets one of the criteria for treatment as a capital lease (refer to paragraph .103), the seller-lessee shall account for the lease as a capital lease; otherwise, as an operating lease. Any profit or loss on the sale28 shall be deferred and amortized in proportion to the amortization of the lease asset29, if a capital lease, or in proportion to the related gross rental charged to expense over the lease term, if an operating lease, unless:

a. The seller-lessee relinquishes the right to substantially all of the remaining use of the property sold (retaining only a minor portion of such use),30 in which case the sale and the leaseback shall be accounted for as separate transactions based on their respective terms. However, if the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease, an appropriate amount shall be deferred or accrued, by adjusting the profit or loss on the sale, and amortized as specified in the introduction of this paragraph to adjust those rentals to a reasonable amount.

28 Profit or loss on the sale is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on
the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

29 If the leased asset is land only, the amortization shall be on a straight-line basis over the lease term. [FAS13, ¶33, fn23]

30 *Substantially all and minor* are used here in the context of the concepts underlying the classification criteria of this section. In that context, a test based on the 90-percent recovery criterion of paragraph .103(d) could be used as a guideline; that is, if the present value of a reasonable amount of rental for the leaseback represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the [buyer-lessor] the right to substantially all of the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use. [FAS28, ¶3a]

b. The seller-lessee retains more than a minor part but less than substantially all[31] of the use of the property through the leaseback and realizes a profit on the sale[32] in excess of (1) the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or (2) the recorded amount of the leased asset, if the leaseback is classified as a capital lease. In that case, the profit on the sale in excess of either the present value of the minimum lease payments or the recorded amount of the leased asset, whichever is appropriate, shall be recognized at the date of the sale. For purposes of applying this provision, the present value of the minimum lease payments for an operating lease shall be computed using the interest rate that would be used to apply the 90 percent recovery criterion of paragraph .103(d).

c. If the lease meets the criteria in paragraphs .103 and .104, the [buyer-lessor] shall record the transaction as a purchase and a direct financing lease; otherwise, the [buyer-lessor] shall record the transaction as a purchase and an operating lease. [FAS 13, paragraph 34]

31 *Substantially all* is used here in the context of the concepts underlying the classification criteria of this section. In that context, if a leaseback of the entire property sold meets the criteria of this section for classification as a capital lease, the seller-lessee would be presumed to have retained substantially all of the remaining use of the property sold. [FAS28, ¶3b]

32 Profit or loss on the sale is used in this paragraph to refer to the profit or loss that would be recognized on the sale if there were no leaseback. For example, on a sale of real estate subject to Section R10, the profit on the sale to be deferred and amortized in proportion to the leaseback would be the profit that could otherwise be recognized in accordance with that section. [FAS28, ¶3]

Sale-Leaseback Transactions Involving Real Estate

.130A Paragraphs .130A through .130M [present] standards of financial accounting and reporting by a seller-lessee for sale-leaseback transactions involving real estate, including real estate with equipment, such as manufacturing facilities, power plants, and office buildings with furniture and fixtures. A sale-leaseback transaction involving real estate with equipment includes any sale-leaseback transaction in which the equipment and the real estate are sold and leased back as a package, irrespective of the relative value of the equipment and the real estate. Those paragraphs also address sale-leaseback transactions in which the seller-lessee sells property improvements or integral equipment[32a] to a buyer-lessor and leases them back while retaining the underlying land.[32b]

32a The terms *property improvements or integral equipment* as used in paragraphs .130A through .130M of this section refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]
Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

Sale-Leaseback Accounting

Sale-leaseback accounting is a method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale in accordance with [paragraphs .129 and .130A through .130M] and Section R10, and classifies the leaseback in accordance with this section. [FAS98, paragraph 70]

Criteria for Sale-Leaseback Accounting

Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph .130D
b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs .111 through .119 of Section R10)
c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee described in paragraphs .130G through .130I of this section and paragraphs .128 through .142 and .144 through .146 of Section R10. [FAS98, paragraph 7]

A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions or conditions described in paragraphs .130G through .130I of this section. The phrase active use of the property by the seller-lessee refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased back property is minor. If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, is considered active use. [FAS98, paragraph 8]

32b Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraphs .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

Sale-Leaseback Accounting

Sale-leaseback accounting is a method of accounting for a sale-leaseback transaction in which the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale in accordance with [paragraphs .129 and .130A through .130M] and Section R10, and classifies the leaseback in accordance with this section. [FAS98, paragraph 70]

Criteria for Sale-Leaseback Accounting

Sale-leaseback accounting shall be used by a seller-lessee only if a sale-leaseback transaction includes all of the following:

a. A normal leaseback as described in paragraph .130D
b. Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property (refer to paragraphs .111 through .119 of Section R10)
c. Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee described in paragraphs .130G through .130I of this section and paragraphs .128 through .142 and .144 through .146 of Section R10. [FAS98, paragraph 7]

A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for payment of rent, including contingent rentals that are based on the future operations of the seller-lessee, and excludes other continuing involvement provisions or conditions described in paragraphs .130G through .130I of this section. The phrase active use of the property by the seller-lessee refers to the use of the property during the lease term in the seller-lessee's trade or business, provided that subleasing of the leased back property is minor. If the present value of a reasonable amount of rental for that portion of the leaseback that is subleased is not more than 10 percent of the fair value of the asset sold, the leased back property under sublease is considered minor. Active use of the property may involve the providing of services where the occupancy of the property is generally transient or short-term and is integral to the ancillary services being provided. Those ancillary services include, but are not limited to, housekeeping, inventory control, entertainment, bookkeeping, and food services. Thus, the use of property by a seller-lessee engaged in the hotel or bonded warehouse business or the operation of a golf course or a parking lot, for example, is considered active use. [FAS98, paragraph 8]

32c Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessor. The latter type of contingent rental is addressed in paragraph .130H(e) of this section. [FAS98, ¶6, fn4]

32d The term minor is used here in the context of the definition in footnote 30 to paragraph .129. [FAS98, ¶6, fn6]
Terms of the Sale-Leaseback Transaction

.130E Terms of the sale-leaseback transaction that are substantially different from terms that an independent third-party lessor or lessee would accept represent an exchange of some stated or unstated rights or privileges. Those rights or privileges shall be considered in evaluating the continuing involvement provisions in paragraphs .130G through .130I of this section. Those terms or conditions include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. The fair value of the property used in making that evaluation shall be based on objective evidence, for example, an independent third-party appraisal or recent sales of comparable property. [FAS98, ¶9]

Continuing Involvement

.130F A sale-leaseback transaction that does not qualify for sale-leaseback accounting because of any form of continuing involvement by the seller-lessee other than a normal leaseback shall be accounted for by the deposit method or as a financing, whichever is appropriate under Section R10. The provisions or conditions described in paragraphs .130G through .130I of this section are examples of continuing involvement for the purpose of applying paragraphs .130A through .130M. [FAS98, ¶10]

.130G Paragraphs .128 thorough .142 and .144 thorough .146 of Section R10 describe forms of continuing involvement by the seller-lessee with the leased property that result in the seller-lessee not transferring the risks or rewards of ownership to the buyer-lessor. Two examples of continuing involvement specified in those paragraphs that are frequently found in sale-leaseback transactions are provisions or conditions in which:

a. The seller-lessee has an obligation or an option\(^{32e}\) to repurchase the property or the buyer-lessor can compel the seller-lessee to repurchase the property.

b. The seller-lessee guarantees the buyer-lessor's investment or a return on that investment for a limited or extended period of time. [FAS98, ¶11]

\(^{32e}\) A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase. An agreement that allows the seller-lessee to repurchase the asset in the event no third-party offer is made is an option to repurchase. [FAS98, ¶11, fn7]

.130H Other provisions or conditions that are guarantees and that do not transfer all of the risks of ownership shall constitute continuing involvement for the purpose of applying paragraphs .130A through .130M to sale-leaseback transactions and include, but are not limited to, the following:

a. The seller-lessee is required to pay the buyer-lessor at the end of the lease terms for a decline in the fair value of the property below the estimated residual value on some basis other than excess wear and tear of the property levied on inspection of the property at the termination of the lease.

b. The seller-lessee provides nonrecourse financing to the buyer-lessor for any portion of the sales proceeds or provides recourse financing in which the only recourse is to the leased asset.

c. The seller-lessee is not relieved of the obligation under any existing debt related to the property.

d. The seller-lessee provides collateral on behalf of the buyer-lessor other than the property directly involved in the sale-leaseback transaction, the seller-lessee or a related party to the seller-lessee guarantees the buyer-lessor's debt, or a related party to the seller-lessee guarantees a return of or on the buyer-lessor's investment.

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The seller-lessee’s rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessee.\(^{32f}\) [FAS98, ¶12]

\(^{32f}\) Paragraphs .130A through .130M distinguish between contingent rentals that are based on the future operations of the seller-lessee and those that are based on some predetermined or determinable level of future operations of the buyer-lessee. [FAS98, ¶8, fn4]

The following provisions or conditions also shall be considered examples of continuing involvement for the purpose of applying paragraphs .130A through .130M to sale-leaseback transactions:

a. The seller-lessee enters into a sale-leaseback transaction involving property improvements or integral equipment\(^{32g}\) without leasing the underlying land to the buyer-lessee.\(^{32h}\)
b. The buyer-lessee is obligated to share with the seller-lessee any portion of the appreciation of the property.
c. Any other provision or circumstance that allows the seller-lessee to participate in any future profits of the buyer-lessee or the appreciation of the leased property, for example, a situation in which the seller-lessee owns or has an option to acquire any interest in the buyer-lessee. [FAS98, ¶13]

\(^{32g}\) The terms *property improvements or integral equipment* as used in paragraphs .130A through .130M refer to any physical structure or equipment attached to the real estate, or other parts thereof, that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery. [FAS98, ¶6, fn2]

\(^{32h}\) Paragraphs .141 and .142 of Section R10 address transactions in which the seller sells property improvements to a buyer and leases the underlying land to the buyer of the improvements. Under certain circumstances, paragraph .141 of Section R10 precludes sales recognition for such transactions and requires that they be accounted for as leases of both the land and improvements. Paragraph .130A through .130M of this section are not intended to modify paragraph .141 of Section R10; thus, they do not address a sale-leaseback transaction that does not qualify for sales recognition under the provisions of paragraph .141 of Section R10. However, those paragraphs do address a sale-leaseback transaction that qualifies for sales recognition under the provisions of paragraph .142 of Section R10. [FAS98, ¶6, fn3]

Financial Statement Presentation and Disclosure

.130K In addition to the [other] disclosure requirements of this section and Section R10, the financial statements of a seller-lessee shall include a description of the terms of the sale-leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee’s continuing involvement. [FAS98, ¶17]

.130L The financial statements of a seller-lessee that has accounted for a sale-leaseback transaction by the deposit method or as a financing according to the provisions of this section and Section R10 also shall disclose:

a. The obligation for future minimum lease payments as of the date of the latest balance sheet presented in the aggregate and for each of the five succeeding fiscal years.
b. The total of minimum sublease rentals, if any, to be received in the future under noncancelable subleases in the aggregate and for each of the five succeeding fiscal years. [FAS98, ¶18]
Accounting for and Reporting for Leveraged Leases

.143 From the standpoint of the lessee, leveraged leases shall be classified and accounted for in the same manner as nonleveraged leases. The balance of this section deals with leveraged leases from the standpoint of the lessor. [FAS13, paragraph 41]

.144 For the purposes of this section, a leveraged lease is defined as one having all the following characteristics:

a. Except for the exclusion of leveraged leases from the definition of a direct financing lease as set forth in paragraph .102(b)(2), it otherwise meets that definition. Leases that meet the definition of sales-type leases set forth in paragraph .102 (b)(1) shall not be accounted for as leveraged leases but shall be accounted for as prescribed in paragraph .113.

b. It involves at least three parties: a lessee, a long-term creditor, and a lessor (commonly called an equity participant).

c. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor (although the creditor may have recourse to the specific property leased and the unremitted rentals relating to it). The amount of financing is sufficient to provide the lessor with substantial leverage in the transaction.

d. The lessor’s net investment, as defined in paragraph .145, declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination. Such decreases and increases in the net investment balance may occur more than once.

A lease meeting the preceding definition shall be accounted for by the lessor using the method prescribed in paragraphs .145 through .149. An exception arises if the investment tax credit is accounted for other than stated in paragraphs .145 and .146, in which case the lease shall be classified as a direct financing lease and accounted for in accordance with paragraph .114. A lease not meeting the definition of a leveraged lease shall be accounted for in accordance with its classification under paragraph .102(b). [FAS 13, ¶42]

.145 The lessor shall record its investment in a leveraged lease net of the nonrecourse debt. [37a] The net of the balances of the following accounts shall represent the initial and continuing investment in leveraged leases:

a. Rentals receivable, net of that portion of the rental applicable to principal and interest on the nonrecourse debt.

b. A receivable for the amount of investment tax credit to be realized on the transaction.

c. The estimated residual value of the lease asset. The estimated residual value shall not exceed the amount estimated at the inception of the lease except as provided in footnote 38.

d. Unearned and deferred income consisting of (1) the estimated pretax lease income (or loss), after deducting the initial direct costs, remaining to be allocated to income over the lease term and (2) the investment tax credit remaining to be allocated to income over the lease term.

[37a] Footnote 502 further discusses nonrecourse debt collateralized by a lease receivable
If the lease agreement or commitment, if earlier, includes a provision to escalate minimum lease payments for increases in construction or acquisition cost of the leased property or for increases in some other measure of cost or value, such as general price levels, during the construction or preacquisition period, the effect of any increases that have occurred shall be considered in the determination of "the estimated residual value of the leased property at the inception of the lease" for purposes of this paragraph. [FAS23, ¶10]

The investment in leveraged leases less deferred taxes arising from differences between the pretax accounting income and taxable income shall represent the lessor's net investment in leveraged leases for purposes of computing periodic net income from the lease as described in paragraph .146. [FAS13, ¶43]

Given the original investment and using the projected cash receipts and disbursements over the term of the lease, the rate of return on the net investment in the years in which it is positive shall be computed. The rate is that rate which when applied to the net investment in the years in which the net investment is positive will distribute the net income to those years (refer to Exhibit 154C) and is distinct from the interest rate implicit in the lease. In each year whether positive or not, the difference between the net cash flow and the amount of income recognized, if any, shall serve to increase or reduce the net investment balance. The net income recognized shall be composed of three elements: two, pretax lease income (or loss) and investment tax credit, shall be allocated in proportionate amounts from the unearned and deferred income included in net investment, as described in paragraph .145; the third element is the tax effect of the pretax lease income (or loss) recognized, which shall be reflected in tax expense for the year. The tax effect of the difference between pretax accounting income (or loss) and taxable income (or loss) for the year shall be charged or credited to deferred taxes. The accounting prescribed in paragraph .145 and in this paragraph is illustrated in paragraph .154. [FAS13, ¶44]

The use of the term years is not intended to preclude application of the accounting prescribed in this paragraph to shorter accounting periods. [FAS13, ¶44, fn 25]

If the projected net cash receipts over the term of the lease are less than the lessor's initial investment, the deficiency shall be recognized as a loss at the inception of the lease. Likewise, if at any time during the lease term the application of the method prescribed in paragraphs .145 and .146 would result in a loss being allocated to future years, that loss shall be recognized immediately. This situation might arise in cases in which one of the important assumptions affecting net income is revised (refer to paragraph .148). [FAS13, ¶45]

For purposes of this paragraph, net cash shall be gross cash receipts less gross cash disbursements exclusive of the lessor's initial investment. [FAS13, ¶44, fn 26]

Any estimated residual value and all other important assumptions affecting estimated total net income from the lease shall be reviewed at lease annually. If during the lease term the estimate of the residual value is determined to be excessive and the decline in the residual value is judged to be other than temporary or if the revision of another important assumption changes the estimated total net income from the lease, the rate of return and the allocation of income to positive investment years shall be recalculated from the inception of the lease following the method described in paragraph .146 and using the revised assumption. The accounts constituting the net investment balance shall be adjusted to conform to the recalculated balances, and the change in the net investment shall be recognized as a gain or loss in the year in which the assumption is changed. An upward adjustment of the estimated residual value shall not be made. The accounting prescribed in this paragraph is illustrated in paragraph .154. [FAS13, ¶46]
Refer to paragraphs .521 through .524 for supplemental guidance on the effect of a change in income tax rate on the accounting for leveraged leases.

Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.

Accounting for Income Taxes

Section 127, “Income Taxes,” does not change (a) the pattern of recognition of after-tax income for leveraged leases as required by this section or (b) the allocation of the purchase price in a purchase business combination to acquired leveraged leases as required by paragraphs .140 through .142. Integration of the results of income tax accounting for leveraged leases with the other results of accounting for income taxes under Section 127 is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph .120 of Section 127) for recognition of a tax benefit for deductible temporary differences and carryforwards not related to leveraged leases. A valuation allowance is not necessary if deductible temporary differences and carryforwards will offset taxable amounts from future recovery of the net investment in the leveraged lease. However, to the extent that the amount of deferred tax credits for a leveraged lease as determined under this section differs from the amount of the deferred tax liability related to the leveraged lease that would otherwise result from applying the requirements of Section 127, that difference is preserved and is not a source of taxable income for recognition of the tax benefit of deductible temporary differences and operating loss or tax credit carryforwards. [FAS109, ¶256]

Integration is an issue when all of the following exist:

a. The accounting for a leveraged lease requires recognition of deferred tax credits.

b. The requirements of Section 127 limit the recognition of a tax benefit for deductible temporary differences and carryforwards not related to the leveraged lease.

c. Unrecognized tax benefits could offset taxable amounts that result from future recovery of the net investment in the leveraged lease.

In those circumstances, integration shall be required. However, integration should not override any results that are unique to income tax accounting for leveraged leases, for example, the manner of recognizing the tax effect of an enacted change in tax rates. [FAS109, ¶126]

Paragraph .141 requires that the tax effect of any difference between the assigned value and the tax basis of a leveraged lease at the date of a business combination not be accounted for as a deferred tax credit. Section 127 does not change that requirement. Any tax effects included in unearned and deferred income as required by this section are not offset by the deferred tax consequences of other temporary differences or by the tax benefit of operating loss or tax credit carryforwards. However, deferred tax credits that arise after the date of a business combination are accounted for in the same manner as described above for leveraged leases that were not acquired in a purchase business combination. [FAS109, ¶257] [Exhibit 185A in Section 127 presents an example that integrates the accounting for leveraged leases [as required by this section] and the accounting for income taxes required by Section 127. [FAS109, ¶258]

Disclosures

For purposes of presenting the investment in a leveraged lease in the lessor’s balance sheet, the amount of related deferred taxes shall be presented separately (from the remainder of the net investment). In the income statement or the notes thereto, separate presentation (from each other) shall be made of pretax income from the leveraged lease, the tax effect of pretax income, and the amount of investment tax credit recognized as income during the period. When leveraged leasing is a significant part of the lessor’s business activities in terms of revenue, net income, or assets, the components of the net investment balance in leveraged leases as set forth
in paragraph .145 shall be disclosed in the footnotes to the financial statements. Paragraph .154 contains an illustration of the balance sheet, income statement and footnote presentation for a leveraged lease. [FAS13, ¶47]

.401 Bargain purchase option. A provision allowing the lessee, at his option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS 13, paragraph 5d].

.402 Bargain renewal option. A provision allowing the lessee, at [the lessee's] option, to renew the lease for a rental sufficiently lower than the fair rental of the property at the date the option becomes exercisable that exercise of the option appears, at the inception of the lease, to be reasonably assured. [FAS13, ¶5e]

Fair Rental in this context shall mean the expected rental for equivalent property under similar terms and conditions. [FAS13, ¶5, fn 2]

.404 Contingent rentals. The increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based, except as provided in the following sentence. Any escalation of minimum lease payments relating to increases in construction or acquisition cost of the leased property or for increases in some measure of cost or value during the construction or preconstruction period, as discussed in footnote 13, shall be excluded from contingent rentals. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. However, lease payments that depend on an existing index or rate, such as the consumer price index or the prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease; any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and thus affect the determination of income as accruable. [FAS29, ¶11]

.406 Estimated economic life of leased property. The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term. [FAS 13, paragraph 5g].

.409 Fair value of the leased property. The price for which the property could be sold in an arms-length transaction between unrelated parties. The following are examples of the determination of fair value:

a. When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value shall be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price and, in some instances, less than the cost of the property.

b. When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will ordinarily be its cost, reflecting any volume or trade discounts that may be applicable. However, when there has been a significant lapse of time between the acquisition of the property by the lessor and the inception of the lease, the determination of fair value shall be made in light of market conditions prevailing at the inception of the lease, which may indicate that
the fair value of the property is greater or less than its cost or carrying amount, if different, (refer to paragraph .102). [FAS 13, paragraph 5c].

.412 Interest rate implicit in the lease. The discount rate that, when applied to (a) the minimum lease payments, excluding that portion of the payments representing executory costs to be paid by the lessor, together with any profit thereon, and (b) the unguaranteed residual value accruing to the benefit of the lessor causes the aggregate present value at the beginning of the lease term to be equal to the fair value of the leased property to the lessor at the inception of the lease, minus any investment tax credit retained by the lessor and expected to be realized by him. (This definition does not necessarily purport to include all factors that a lessor might recognize in determining his rate of return, for example, see paragraph .146.) [FAS 13, paragraph 5k]

403 If the lessor is not entitled to any excess of the amount realized on disposition of the property over a guaranteed amount, no unguaranteed residual value would accrue to the lessors benefit. [FAS 13, paragraph 5k, footnote 8]

.413 Lease. An agreement conveying the right to use property, plant, or equipment (land or depreciable assets or both) usually for a stated period of time. [FAS 13, paragraph 1].

.414 Lease term. The fixed noncancelable term of the lease plus (a) all periods, if any, covered by bargain renewal options (as defined paragraph .402), (b) all periods, if any, for which failure to renew the lease imposes a penalty (as defined in paragraph .418A) on the lessee in such amount that a renewal appears, at the inception of the lease, to be reasonably assured, (c) all periods, if any, covered by ordinary renewal options during which a guarantee by the lessee of the lessors debt directly or indirectly related to the leased property is expected to be in effect or a loan from the lessee to the lessor directly or indirectly related to the leased property is expected to be outstanding, (d) all periods, if any, covered by ordinary renewal options preceding the date as of which a bargain purchase option (as defined in paragraph .401) is exercisable, and (e) all periods, if any, representing renewals or extensions of the lease at the lessors option; however, in no case shall the lease term be assumed to extend beyond the date a bargain purchase option becomes exercisable. A lease that is cancelable (1) only upon the occurrence of some remote contingency, (2) only with the permission of the lessor, (3) only if the lessee incurs a penalty in such amount that continuation of the lease appears, at inception, reasonably assured shall be noncancelable for purposes of this definition. [FAS 98, paragraph 22a]

405 Paragraphs .501 through .505 address fiscal funding clauses in lease agreements.

405a The phrase indirectly related to the leased property is used in this paragraph to describe provisions or conditions that in substance are guarantees of the lessors debt or loans to the lessor by the lessee that are related to the leased property but are structured in such a manner that they do not represent a direct guarantee or loan. Examples include a party related to the lessee guaranteeing the lessors debt on behalf of the lessee, or the lessee financing the lessors purchase of the leased asset using collateral other than the leased property. [FAS 98, paragraph 22a]

.415 Lessees incremental borrowing rate. The rate that, at the inception of the lease, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset. [FAS 13, paragraph 5l, footnote 8]

406 Paragraphs .509 through .511 further discuss the interest rate used in calculating the present value of the minimum lease payments.
Minimum lease payments.

(a) From the standpoint of the lessee: The payments that the lessee is obligated to make or can be required to make in connection with the leased property. [FAS 13, paragraph 5j], (Contingent rentals, as defined in paragraph .404, shall be excluded from minimum lease payments.) [FAS 29, paragraph 10] However, a guarantee by the lessee of the lessors debt and the lessees obligation to pay (apart from the rental payments) executory costs in connection with the leased property shall be excluded. If the lease contains a bargain purchase option, only the minimum rental payments over the lease term (as defined in paragraph .413) and the payment called for by the bargain purchase option shall be included in the minimum lease payments. Otherwise, minimum lease payments include the following:

1. The minimum rental payments called for by the lease over the lease term.

2. Any guarantee by the lessee or any party related to the lessee of the residual value at the expiration of the lease term, whether or not payment of the guarantee constitutes a purchase of the leased property. When the lessor has the right to require the lessee to purchase the property at termination of the lease for a certain or determinable amount, that amount shall be considered a lessee guarantee. When the lessee agrees to make up any deficiency below a stated amount in the lessors realization of the residual value, the guarantee to be included in the minimum lease payments shall be the stated amount, rather than an estimate of the deficiency to be made up.

3. Any payment that the lessee must make or can be required to make upon failure to renew or extend the lease at the expiration of the lease term, whether or not the payment would constitute a purchase of the lease property. In this connection, it should be noted that the definition of lease term (refer to paragraph .413) includes all periods, if any, for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. If the lease term has been extended because of that provision, the related penalty shall not be included in the minimum lease payments.
(b) From the standpoint of the lessor: The payments described above plus any guarantee of the residual value or of rental payments beyond the lease term by a third party unrelated to either the lessee of the lessor, provided the third party is financially capable of discharging the obligations that may arise from the guarantee. [FAS 13, paragraph 5j]

410 If the guarantor is related to the lessor, the residual value shall be considered as unguaranteed.

.418A Penalty. Any requirement that is imposed or can be imposed on the lessee by the lease agreement or by factors outside the lease agreement to disburse cash, incur or assume a liability, perform services, surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider when determining if an economic detriment may be incurred include, but are not limited to, the uniqueness of purpose or location of the property, the availability of a comparable replacement property, the relative importance or significance of the property to the continuation of the lessee's line of business or service to its customers, the existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the leased property, adverse tax consequences, and the ability or willingness of the lessee to bear the cost associated with relocation or replacement of the leased property at market rental rates or to tolerate other parties using the leased property. [FAS98, ¶22b]

.419 Related parties. A parent company and its subsidiaries, an owner company and its joint ventures (corporate or otherwise) and partnerships, and an investor (including a natural person) and its investees, provided that the parent company, owner enterprise, or investor has the ability to exercise significant influence over operating and financial policies of the related party, as significant influence is defined in section I82, paragraph 104. In addition to the examples of significant influence set forth in that paragraph, significant influence may be exercised through guarantees of indebtedness, extensions of credit, or through ownership of warrants, debt obligations, or other securities. If two or more enterprises are subject to the significant influence of a parent company, owner enterprise, investor (including a natural person), or common officers or directors, those enterprises shall be considered related parties with respect to each other. [FAS 13, paragraph 5a].

30. FAS 66, Accounting for Sales of Real Estate, defines the deposit method of accounting as follows:

Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment at the time the sale is consummated.[FAS66, ¶7]

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the
buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.

31. FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, provides the following guidance:

**Question**

1. Certain operating lease agreements specify scheduled rent increases over the lease term. Such scheduled rent increases may, for example, be designed to provide an inducement or “rent holiday” for the lessee, to reflect the anticipated effects of inflation, to ease the lessee's near-term cash flow requirements, or to acknowledge the time value of money. For operating leases that include scheduled rent increases, is it ever appropriate for lessees or lessors to recognize rent expense or rental income on a basis other than the straight-line basis required by Statement 13?

**Response**

2. The effects of those scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term unless another systematic and rational allocation basis is more representative of the time pattern in which the leased property is physically employed. Using factors such as the time value of money, anticipated inflation, or expected future revenues to allocate scheduled rent increases is inappropriate because these factors do not relate to the time pattern of the physical usage of the leased property. However, such factors may affect the periodic reported rental income or expense if the lease agreement involves contingent rentals, which are excluded from minimum lease payments and accounted for separately under Statement 13, as amended by Statement 29.

32. FASB Technical Bulletin 88-1, *Issues relating to Accounting for Leases: Time Pattern of the Physical Use of the Property in an Operating Lease, Lease Incentives in an Operating Lease, Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor, Money-Over-Money Lease Transactions, Wrap Lease Transactions*, provides the following guidance on operating leases:

**TIME PATTERN OF THE PHYSICAL USE OF THE PROPERTY IN AN OPERATING LEASE**

References: FASB Statement No. 13, Accounting for Leases, paragraph 15

FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases

**Question 1**

1. A lease agreement may include scheduled rent increases designed to accommodate the lessee's projected physical use of the property. For example, rents may escalate in contemplation of the lessee's physical use of the property even though the lessee takes possession of or controls the physical use of the property at the inception of the lease, or rents may escalate under a master lease agreement as the lessee adds additional equipment to the leased property or requires additional space or capacity (hereinafter referred to as additional leased property). For operating leases that include those provisions, how should the rental payment obligation be recognized by the lessee and lessor in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

**Response**

2. Both the lessee and the lessor should recognize the lease payments under Statement 13 and Technical Bulletin 85-3 as follows:
a. If rents escalate in contemplation of the lessee's physical use of the leased property, including equipment, but the lessee takes possession of or controls the physical use of the property at the beginning of the lease term, all rental payments, including the escalated rents, should be recognized as rental expense or rental revenue on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3 starting with the beginning of the lease term.

b. If rents escalate under a master lease agreement because the lessee gains access to and control over additional leased property at the time of the escalation, the escalated rents should be considered rental expense or rental revenue attributable to the leased property and recognized in proportion to the additional leased property in the years that the lessee has control over the use of the additional leased property. The amount of rental expense or rental revenue attributed to the additional leased property should be proportionate to the relative fair value of the additional property, as determined at the inception of the lease, in the applicable time periods during which the lessee controls its use.

Background

3. This issue involves how to apply Technical Bulletin 85-3 to lease agreements that escalate rents in contemplation of the lessee's projected use of the property. The issue arises from paragraph 2 of Technical Bulletin 85-3, which states "... scheduled rent increases, which are included in minimum lease payments under Statement 13, should be recognized by lessors and lessees on a straight-line basis over the lease term UNLESS ANOTHER SYSTEMATIC AND RATIONAL ALLOCATION BASIS IS MORE REPRESENTATIVE OF THE TIME PATTERN IN WHICH THE LEASED PROPERTY IS PHYSICALLY EMPLOYED" (emphasis added).

4. This Technical Bulletin considers the right to control the use of the leased property as the equivalent of physical use. When the lessee controls the use of the leased property, recognition of rental expense or rental revenue should not be affected by the extent to which the lessee utilizes that property.

5. This Technical Bulletin makes a distinction between agreements that give the lessee the right to control the use of the leased property at the beginning of the lease term and those that do not. Escalated rents under agreements that give the lessee the right to control the use of the entire leased property at the beginning of the lease term should be included in the minimum lease payments and recognized on a straight-line basis over the lease term. When the agreement provides that the lessee gains control over additional leased property, rental expense or rental revenue should be recognized based on the relative fair value of the additional property leased and the period during which the lessee has the right to control the use of the additional property. This is the intent of Statement 13 and Technical Bulletin 85-3.

LEASE INCENTIVES IN AN OPERATING LEASE

References: FASB Statement No. 13, Accounting for Leases, paragraphs 15, 19, and 35-40

FASB Technical Bulletin No. 79-15, Accounting for Loss on a Sublease Not Involving the Disposal of a Segment

FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases

Question 2

6. An operating lease agreement with a new lessor may include incentives for the lessee to sign the lease, such as an up-front cash payment to the lessee, payment of costs for the lessee (such as moving expenses), or the assumption by the lessor of the lessee's preexisting lease with a third party. For operating leases that include such incentives, should lessees or lessors ever
recognize those incentives as rental expense or rental revenue other than on a straight-line basis in accordance with paragraph 15 of Statement 13 and Technical Bulletin 85-3?

Response

7. Payments made to or on behalf of the lessee represent incentives that should be considered reductions of rental expense by the lessee and reductions of rental revenue by the lessor over the term of the new lease. Similarly, losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party should be considered an incentive by both the lessor and the lessee. Incentives should be recognized on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraphs 1-5 above.

8. The lessee's immediate recognition of expenses or losses, such as moving expenses, losses on subleases, or the write-off of abandoned leasehold improvements, is not changed by this Technical Bulletin. Rather, this Technical Bulletin addresses the question of when to recognize the incentive related to the new lessor's assumption of that expense or loss. The new lessor and the lessee should independently estimate any loss attributable to the assumption of a preexisting lease with a third party. For example, the lessee's estimate of the incentive could be based on a comparison of the new lease with the market rental rate available for similar lease property or the market rental rate from the same lessor without the lease assumption, and the lessor should estimate any loss based on the total remaining costs reduced by the expected benefits from the sublease or use of the assumed leased property.

9. For example, in conjunction with an operating lease of property for eight years, the lessor assumes the lessee's preexisting lease with a third party that has four years remaining. Assume that the old lease payment is $800 per year and the new lease payment is $1,200 per year. Also assume that the lessor estimates the loss on the assumed lease of $1,000 over its remaining term based on the ability to sublease the property for $550 per year. The lessee estimates the incentive as $960 based on a comparison of the preexisting lease rate to current rates for similar property. The accounting for that incentive is as follows:

Lessor Accounting

At inception:

Incentive to lessee 1,000
Liability on sublease assumed 1,000

To record deferred cost and liability related to loss on assumption of remaining lease

Recurring journal entries in years 1-4:

Liability on sublease assumed (1,000/ 4 years) 250
Sublease expense 550
    Cash 800

To record cash payment on sublease assumed and amortization of the liability on the sublease assumed

Cash 550
    Sublease revenue 550
To record cash received from sublease of the property

Recurring journal entries in years 1-8:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,200</td>
</tr>
<tr>
<td>Rental revenue</td>
<td>1,075</td>
</tr>
<tr>
<td>Incentive to lessee (1,000/8 years)</td>
<td>125</td>
</tr>
</tbody>
</table>

To record cash received on new lease and amortization of incentive over new lease term

Lessee Accounting

At inception:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on sublease assumed by lessor</td>
<td>960</td>
</tr>
<tr>
<td>Incentive from lessor</td>
<td>960</td>
</tr>
</tbody>
</table>

To record loss on sublease assumed in conjunction with new lease agreement

Recurring journal entries in years 1-8:

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease expense</td>
<td>1,080</td>
</tr>
<tr>
<td>Incentive from lessor (960/8 years)</td>
<td>120</td>
</tr>
<tr>
<td>Cash</td>
<td>1,200</td>
</tr>
</tbody>
</table>

To record cash payment on new lease and amortization of incentive over the new lease term

Background

10. Some have suggested that incentives paid to or incurred on behalf of the lessee by the lessor are not part of the normal lessee-lessee relationship and should be recognized in income by the lessee in the period paid or incurred by the lessor. This Technical Bulletin views those incentives as an inseparable part of the new lease agreement that must be recognized as reductions to rental expense and rental revenue on a straight-line basis over the term of the new lease in accordance with paragraph 15 of Statement 13, Technical Bulletin 85-3, and paragraph 2 above.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 25 - Accounting for and Disclosures About Transactions with Affiliates and Other Related Party Transactions
- Issue Paper No. 34 - Investment Income Due and Accrued
- Issue Paper No. 40 - Real Estate Investments
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 8 and 22
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 8
Generally Accepted Accounting Principles
GAAP guidance applicable to operating leases, sale-leaseback transactions and leveraged leases, which is adopted and rejected is indicated in brackets paragraphs:

- FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted by incorporating FASB Statements, Interpretations, and Technical Bulletins, which follow. [paragraphs 15, 16(b, c, d), 19(a, b), 23(b, c), 36, 37, 38(b), 39(c), 42-47 adopted; all other paragraphs rejected]
- FASB Statement No. 22, *Changes in the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt* (an amendment of FASB Statement No. 13) [rejected in its entirety]
- FASB Statement No. 23, *Inception of the Lease* (an amendment of FASB Statement No. 13) [paragraph 10 adopted; all other paragraphs rejected]
- FASB Statement No. 27, *Classification of Renewals or Extensions of Existing Sales-Type or Direct Financing Leases* (an amendment of FASB Statement No. 13) [rejected in its entirety]
- FASB Statement No. 28, *Accounting for Sales with Leasebacks* (an amendment of FASB Statement No. 13) [adopted in its entirety, except guidance on capital leases is not applicable other than those leases that qualify as leveraged leases.]
- FASB Statement No. 29, *Determining Contingent Rentals* (an amendment of FASB Statement No. 13) [paragraphs 8, 11 adopted; remaining paragraphs rejected]
- FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate*
  - *Sales-Type Leases of Real Estate*
  - *Definition of the Lease Term*
  - *Initial Direct Costs of Direct Financing Leases* (an amendment of FASB Statements No. 13, 66 and 91 and a recession of FASB Statement No. 26 and Technical Bulletin No. 79-11) [paragraphs 1-13, 17-22(a-e, j-n) adopted; remaining paragraphs rejected]
- FASB Statement No. 109, *Accounting for Income Taxes* [paragraphs 256-258 adopted]
- FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property* (an interpretation of FASB Statement No. 13) [rejected in its entirety]
- FASB Interpretation No. 21, *Accounting for Leases in a Business Combination* (an interpretation of FASB Statement No. 13) [rejected in its entirety]
- FASB Interpretation No. 23, *Leases of Certain Property Owned by a Governmental Unit or Authority* (an interpretation of FASB Statement No. 13) [rejected in its entirety]
- FASB Interpretation No. 24, *Leases Involving Only Part of a Building* (an interpretation of FASB Statement No. 13) [rejected in its entirety]
- FASB Interpretation No. 26, *Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease* (an interpretation of FASB Statement No. 13) [rejected in its entirety]
- FASB Interpretation 27, *Accounting for a Loss on a Sublease* (an interpretation of FASB Statement No. 13 and APB Opinion No. 30) [adopted in its entirety]
- FASB Technical Bulletin 79-10, *Fiscal Funding Clauses in Lease Agreements* [rejected in its entirety.]
- FASB Technical Bulletin 79-12, *Interest Rate Used in Calculating the Present Value of Minimum Lease Payments* [rejected in its entirety]
- FASB Technical Bulletin 79-14, *Upward Adjustment of Guaranteed Residual Values* [rejected in its entirety]
- FASB Technical Bulletin 79-16(R), *Effect of a change in Income Tax Rate on the Accounting for Leveraged Leases* [adopted in its entirety]
- FASB Technical Bulletin 79-17, *Reporting Cumulative Effect Adjustment from Retroactive Application of FASB Statement No. 13* [rejected in its entirety]
- FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases* [adopted in its entirety]
  - *Acquired by a Third Party or*  
  - *Retained by a Lessor That Sells the Related Minimum Rental Payments* [adopted in its entirety]
- FASB Technical Bulletin 88-1, *Issues Related to Accounting for Leases:*  
  - *Time Pattern of the Physical Use of the Property in an Operating Lease*  
  - *Lease Incentives in an Operating Lease*  
  - *Applicability of Leveraged Lease Accounting to Existing Assets of the Lessor*  
  - *Money-Over-Money Lease Transactions*  
  - *Wrap Lease Transactions*  
  [paragraphs 1-12 adopted; remaining paragraphs rejected]

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 23
Property Occupied by the Company

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A reporting entity is required to record its investment in real estate that is occupied by the company as a separate line item in the Invested Asset section of the statutory balance sheet. Additionally, a reporting entity is required to record rental income and expense related occupancy of its own building. Under GAAP, property used predominantly in a reporting entity’s operations is classified as an asset outside of invested assets. Additionally, GAAP prohibits the recognition of imputed investment income and rental expense for real estate used in the business.

2. The purpose of the issue paper is to establish statutory accounting principles for home office that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For statutory accounting purposes, any real estate which is owned by and is more than 50% occupied by the reporting entity and its affiliates shall be considered “real estate occupied by the company.” “More than 50% occupied” shall mean that the square footage occupied by the reporting entity and its affiliates totals more than 50% of the rentable square footage of the property, including common areas. This shall include property occupied by the reporting entity which is not necessarily home office (e.g. claims processing, data processing and branch centers). Property which does not meet this 50% requirement shall be classified as property held for the production of income or property held for sale.

4. A reporting entity’s investment in property occupied by the company meets the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) and is an admitted asset to the extent it conforms to the requirements of this issue paper. The asset shall be recorded in accordance with Issue Paper No. 40 - Real Estate Investments (Issue Paper No. 40) (e.g., initial capitalization, valuation, including impairments of value, depreciation, interest expense on encumbrances, etc.). A reporting entity shall include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. The amount recorded shall be at a rate comparable to rent received from others and/or rental rates of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the reporting entity’s investment in its home office building.

DISCUSSION

5. The conclusion above clarifies current statutory accounting to include specific guidance on the definition of property occupied by the company. Additionally, the conclusion above changes current guidance to require property occupied by the reporting entity to be evaluated for impairment as specified in accordance with Issue Paper No. 40. Current statutory guidance requires property occupied by the company to be valued at depreciated cost (net of any encumbrances). FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of (FAS 121), is adopted in Issue Paper No. 40. The conclusion above rejects paragraph 52 of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60).
6. Recording property occupied by the company, net of any encumbrances, as an admitted asset is consistent with the Recognition Concept included in the Statement of Concepts. The Recognition Concept states,

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

Though in a depressed market it may take longer to liquidate than other invested assets, it is generally accepted that real estate is a marketable asset which is available to meet policyholder obligations.

7. So that the statement of operations and yield on invested assets of a reporting entity occupying its own real estate are comparable with a reporting entity that leases its offices under operating leases, rental income and expense are reported for the real estate occupied by the reporting entity. The rent charged should be comparable to the income that would be produced if the reporting entity was renting the real estate to a third party.

Drafting Notes/Comments
- Accounting for real estate is addressed in Issue Paper No. 40 - Real Estate Investments.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. Chapter 4, Real Estate, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) contains the following guidance on reporting for real estate occupied by the reporting entity:

Directly-owned real estate is reported separately in the statutory financial statement. Holdings so reported are classified as properties (a) occupied by the company, (b) acquired in satisfaction of debt, and (c) investments in real estate. These classes may include real estate owned under contract of sale.

In the statutory financial statement, a company must include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. This amount can be the estimate current market rental value of the space involved, or it can be the amount derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the company's investment in its home office building. The figure thus determined, being both charged to expenses and credited to income, has no effect either on the company's overall net income or surplus.


Rent on Company-Owned Office Building

Real estate income from company-owned property includes rent received from the leasing of space to others and also an imputed rental charge for the portion of the building occupied by the company. This rental charge is made on the theory that such space can be rented to others; therefore, the company is entitled to income on its investment. Some states require that this rent be comparable to rent received from others and/or rental rates of like property in the same area. It should be noted that an offsetting charge is made to rent expense.


Generally Accepted Accounting Principles

12. FAS 60, *Accounting and Reporting by Insurance Enterprises*, contains the guidance relating to real estate occupied by the reporting entity. It states:

Real Estate Used in the Business

52. Real estate shall be classified either as an investment or as real estate used in the enterprise's operations, depending on its predominant use. Depreciation and other real estate operating costs shall be classified as investment expenses or operating expenses consistent with the balance sheet classification of the related asset. Imputed investment income and rental expense shall not be recognized for real estate used in the business.

13. FAS 121 contains the following guidance for real estate occupied by the reporting entity:

Assets to Be Held and Used

Recognition and Measurement of Impairment

4. An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

5. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:

   a. A significant decrease in the market value of an asset
   b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
   c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
   d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
   e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

6. If the examples of events or changes in circumstances set forth in paragraph 5 are present or if other events or changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash
outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement. Otherwise, an impairment loss shall not be recognized; however, a review of depreciation policies may be appropriate.¹

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¹ Paragraph 10 of APB Opinion No. 20, Accounting Changes, addresses the accounting for changes in depreciation estimates, and paragraph 32 addresses the accounting for changes in the method of depreciation. Whenever there is reason to assess the recoverability of the carrying amount of an asset under paragraphs 4 and 5 of this Statement, there may be reason to review the depreciation estimates and method under paragraphs 10 and 32 of Opinion 20. However, an impairment loss that results from applying this Statement should be recognized prior to performing that review. The provisions of Opinion 20 apply to the reporting of changes in the depreciation estimates and method regardless of whether an impairment loss is recognized under paragraph 6 of this Statement.

7. An impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

8. In estimating expected future cash flows for determining whether an asset is impaired (paragraph 6), and if expected future cash flows are used in measuring assets that are impaired (paragraph 7), assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

9. Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

10. In limited circumstances, the test specified in paragraph 6 will be applicable at only the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings. In those instances, if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of this Statement. If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement.

11. After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For a depreciable asset, the new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 19, Investment Income and Net Realized Gains
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 15, Investment Income and Net Realized Gains
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 40 - Real Estate Investments

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 24
Discontinued Operations and Extraordinary Items

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance does not define nor does it address the accounting treatment for the disposal of a segment of a business or extraordinary items.

2. GAAP guidance contained in Accounting Principles Board Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, as amended (APB 30) defines discontinued operations, requires accrual of losses associated with the disposal of a segment of a business and states that results of operations of discontinued operations should be disclosed as a separate line item in the balance sheet and in the income statement after income from the on-going operations of the reporting entity, net of applicable income taxes. It also contains guidance on the calculation of the gain or loss on the disposal of a segment of the business. Gains on the disposal of a segment of the business are not to be recorded until realized.

3. APB 30 also defines extraordinary items and requires extraordinary items to be disclosed as a separate line item in the income statement after income from the on-going operation of the reporting entity, net of applicable income taxes.

4. The purpose of this issue paper is to establish statutory accounting principles related to the accounting and reporting for the effects of the disposal of a segment of a business and extraordinary items that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Discontinued Operations

5. If a loss is expected from the proposed sale or abandonment of a segment of business, the estimated loss shall be accrued at the measurement date, as defined in paragraph 13 below, in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. If a gain is expected, it shall be recognized when realized, in accordance with Issue Paper No. 20 - Gain Contingencies, which ordinarily is the disposal date.

6. The determination of whether a gain or loss results from the disposal should be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal should also include an estimate of such amounts. If it is expected that net income will be generated from operations during that period the computation should include the estimated net income, limited however to the amount of any loss otherwise recognizable for the disposal, with any remainder accounted for when realized. Any changes in the original estimate shall be accounted for in accordance with Issue Paper No. 3 - Accounting Changes.
7. The results of a reporting entity’s discontinued operations shall be reported consistently with the entity’s reporting of continuing operations (i.e. no separate line item presentation in the balance sheet or statement of operations aggregating current and future losses from the measurement date).

8. Additionally, the notes to the financial statements for the period encompassing the measurement date and the year subsequent shall contain the following:
   a. The identity of the segment of business that has been or will be discontinued,
   b. The expected disposal date, if known (see definition in paragraph 13 below),
   c. The expected manner of disposal,
   d. A description of the remaining assets and liabilities of the segment at the balance sheet date and the estimated payout pattern,
   e. The amounts related to the discontinued operations and the effect on the statement of operations including the balance sheet and income statement line items which have been affected.

9. If material revisions are made to the estimates of the cost to dispose of a segment in years subsequent to the disclosure required in paragraph 8 above, the nature and the effect of the revisions to the estimates shall be disclosed for the period in which the revision was made including the effect on income or loss from operations and the effect on the carrying amount of the remaining assets and liabilities of the segment at the balance sheet date.

Extraordinary Items
10. Extraordinary items, as defined in paragraph 13 below, shall be reported consistently with the reporting entity’s reporting of continuing operations (i.e. no separate line item presentation in the balance sheet or statement of operations). Such items shall not be charged directly to surplus unless specifically addressed elsewhere within the codification.

11. The nature of an extraordinary event or transaction and the principle items entering into the determination of an extraordinary gain or loss shall be disclosed in the notes to the financial statements. This disclosure shall include the line items which have been affected by the estimate of the extraordinary item.

12. Material events or transactions that are either unusual or occur infrequently, but not both, are not considered extraordinary items. However, such material events or transactions shall be disclosed in the notes to the financial statements.

Definitions
13. For purposes of statutory accounting, the following definitions shall apply:

   “Discontinued operations” shall be defined as the operations of a segment of a business that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal.

   A “segment” of a business shall be defined as a component of an entity, likely in the form of a subsidiary, whose activities represent a separate major type of business or class of customer. The assets, results of operations, and activities of a segment must be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business should be distinguished from other disposals of assets incident to the evolution of the entity’s business, such as the disposal of a line of business or the shifting of marketing activities from one location to another.
“Measurement date” shall be defined as the date on which management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan, at a minimum, should include identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date (defined below), and the estimated proceeds or salvage to be realized by disposal.

“Disposal date” shall be defined as the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment.

“Extraordinary items” shall be defined as those events or transactions which meet both of the following criteria:

(a) Unusual nature - the underlying event or transaction possesses a high degree of abnormality and is clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the reporting entity, taking into account the environment in which the reporting entity operates.

(b) Infrequency of occurrence - the underlying event or transaction would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the reporting entity operates.

DISCUSSION

14. The conclusion above adopts the accounting principles relating to the accounting for the disposal of a segment of a business included in APB No. 30, paragraphs 13 through 18. These paragraphs define certain terminology relevant to the disposal of a segment and set forth criteria for recording a related loss. The conclusion above also adopts the definition of an extraordinary item included in paragraph 20 of APB 30. It rejects all other paragraphs relating to the accounting and reporting of discontinued operations, extraordinary items and unusual or infrequently occurring events and transactions. The conclusion above adopts the interpretations of APB 30 included in Accounting Interpretation of Accounting Principles Board Opinion 30, Reporting the Results of Operations (AIN-APB 30), relating to the definition of extraordinary items and terminology relevant to the disposal of a segment and the criteria for recording a related loss. It rejects all other interpretations of APB 30 relating to the accounting and reporting of discontinued operations, extraordinary items and unusual or infrequently occurring events and transactions. This statement also adopts FASB Emerging Issues Task Force No. 85-36, Discontinued Operations with Expected Gain and Interim Operating Losses.

15. This issue paper rejects FASB Emerging Issues Task Force No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring), and FASB Emerging Issues Task Force No. 95-18, Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements.

16. As stated above, statutory accounting guidance does not address the accounting and reporting for discontinued operations and extraordinary items and industry practice is varied. Predominant practice has been to accrue losses resulting from discontinued operations, however, practice varies as to the presentation of the loss. Some entities record extraordinary items as a charge directly to surplus; other entities do not separate extraordinary items from the results of continuing operations.

17. The conclusion above requires a loss associated with discontinued operations to be recorded at the measurement date. This is consistent with the conservatism concept in the Statement of Concepts. Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets requires an
estimated loss from a loss contingency to be recorded when (a) it is probable that a loss will be incurred and (b) the amount of the loss can be reasonably estimated.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
18. Statutory guidance does not address the accounting treatment for the disposal of a segment or extraordinary items.

Generally Accepted Accounting Principles
19. Accounting Principles Board Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (APB 30), discusses discontinued operations and extraordinary items in the following excerpts:

Income Statement Presentation and Disclosure

8. Discontinued Operations of a Segment of a Business. For purposes of this Opinion, the term discontinued operations refers to the operations of a segment of a business as defined in paragraph 13 that has been sold, abandoned, spun off, or otherwise disposed of or, although still operating, is the subject of a formal plan for disposal (see paragraph 14). The Board concludes that the results of continuing operations should be reported separately from discontinued operations and that any gain or loss from disposal of a segment of a business (determined in accordance with paragraphs 15 and 16) should be reported in conjunction with the related results of discontinued operations and not as an extraordinary item. Accordingly, operations of a segment that has been or will be discontinued should be reported separately as a component of income before extraordinary items and the cumulative effect of accounting changes (if applicable) in the following manner:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>$XXXXX</td>
</tr>
<tr>
<td>Provision for income taxes</td>
<td>XXX</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>$XXXXX</td>
</tr>
<tr>
<td>Discontinued operations(Note______):</td>
<td></td>
</tr>
<tr>
<td>Income (loss) from operations of discontinued Division X</td>
<td>$XXXXX</td>
</tr>
<tr>
<td>(less applicable income taxes of $______)</td>
<td></td>
</tr>
<tr>
<td>Loss on disposal of Division X, including provision of $_____ for operating losses during phase-out period (less applicable income taxes of $______)</td>
<td>XXXX</td>
</tr>
<tr>
<td>Net Income</td>
<td>$XXXXX</td>
</tr>
</tbody>
</table>

Amounts of income taxes applicable to the results of discontinued operations and the gain or loss from disposal of the segment should be disclosed on the face of the income statement or in related notes. Revenues applicable to the discontinued operations should be separately disclosed in the related notes.
2 These captions should be modified appropriately when an entity reports an extraordinary item and/or the cumulative effect of a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*. The presentation of per share data will need similar modification.

11. In the absence of discontinued operations and changes in accounting principles, the following main captions should appear in an income statement if extraordinary items are reported (paragraphs 17-19 of APB Opinion No. 9):

Income before extraordinary items\(^4\) $XXXX
Extraordinary items of less applicable income taxes of $(____) (Note____) XXX

Net income $XXXX
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\(^4\) This caption should be modified appropriately when an entity reports the cumulative effect of an accounting change.

The caption extraordinary items should be used to identify separately the effects of events and transactions, other than the disposal of a segment of a business, that meet the criteria for classification as extraordinary as discussed in paragraphs 19-24. Descriptive captions and the amounts for individual extraordinary events or transactions should be presented, preferably on the face of the income statement, if practicable; otherwise disclosure in related notes is acceptable. The nature of an extraordinary event or transaction and the principal items entering into the determination of an extraordinary gain or loss should be described. The income taxes applicable to extraordinary items should be disclosed on the face of the income statement; alternatively disclosure in the related notes is acceptable. The caption net income should replace the three captions shown above if the income statement includes no extraordinary items.

Accounting for the Disposal of a Segment of a Business

13. For purposes of this Opinion, the term *segment of a business* refers to a component of an entity whose activities represent a separate major line of business or class of customer. A segment may be in the form of a subsidiary, a division, or a department, and in some cases a joint venture or other nonsubsidiary investee, provided that its assets, results of operations, and activities can be clearly distinguished, physically and operationally and for financial reporting purposes, from the other assets, results of operations, and activities of the entity. Financial statements of current and prior periods that include results of operations prior to the measurement date (as defined in paragraph 14) should disclose the results of operations of the disposed segment, less applicable income taxes, as a separate component of income before extraordinary items (see paragraph 8). The fact that the results of operations of the segment being sold or abandoned cannot be separately identified strongly suggests that the transaction should not be classified as the disposal of a segment of the business. The disposal of a segment of a business should be distinguished from other disposals of assets incident to the evolution of the entity's business, such as the disposal of part of a line of business, the shifting of production or marketing activities for a particular line of business from one location to another, the phasing out of a product line or class of service, and other changes occasioned by technological improvements. The disposal of two or more unrelated assets that individually do not constitute a segment of a business should not be combined and accounted for as a disposal of a segment of business.
14. **Definition of Measurement and Disposal Dates.** For purposes of applying the provisions of this Opinion, the measurement date of a disposal is the date on which the management having authority to approve the action commits itself to a formal plan to dispose of a segment of the business, whether by sale or abandonment. The plan of disposal should include, as a minimum, identification of the major assets to be disposed of, the expected method of disposal, the period expected to be required for completion of the disposal, an active program to find a buyer if disposal is to be by sale, the estimated results of operations of the segment from the measurement date to the disposal date, and the estimated proceeds or salvage to be realized by disposal. For purposes of applying this Opinion, the disposal date is the date of closing the sale if the disposal is by sale or the date that operations cease if the disposal is by abandonment.

15. **Determination of Gain or Loss on Disposal of a Segment of a Business.** If a loss is expected from the proposed sale or abandonment of a segment, the estimated loss should be provided for at the measurement date. If a gain is expected, it should be recognized when realized, which ordinarily is the disposal date. The determination of whether a gain or a loss results from the disposal of a segment of a business should be made at the measurement date based on estimates at that date of the net realizable value of the segment after giving consideration to any estimated costs and expenses directly associated with the disposal and, if a plan of disposal is to be carried out over a period of time and contemplates continuing operations during that period, to any estimated income or losses from operations. If it is expected that net losses from operations will be incurred between the measurement date and the expected disposal date, the computation of the gain or loss on disposal should also include an estimate of such amounts. If it is expected that income will be generated from operations during that period the computation of the gain or loss should include the estimated income, limited however to the amount of any loss otherwise recognizable from the disposal; any remainder should be accounted for as income when realized. The Board believes that the estimated amounts of income or loss from operations of a segment between measurement date and disposal date included in the determination of loss on disposal should be limited to those amounts that can be projected with reasonable accuracy. In the usual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.

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5 If financial statements for a date prior to the measurement date have not been issued, and the expected loss provides evidence of conditions that existed at the date of such statements and affects estimates inherent in the process of preparing them, the financial statements should be adjusted for any change in estimates resulting from the use of such evidence. (See Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, paragraph 560.03.)

6 When disposal is estimated to be completed within one year and subsequently is revised to a longer period of time, any revision of the net realizable value of the segment should be treated as a change in estimate (see paragraph 25).

16. **Gain or Loss from the Disposal of a Segment of a Business.** Gain or loss from the disposal of a segment of a business should not include adjustments, costs, and expenses associated with normal business activities that should have been recognized on a going-concern basis up to the measurement date, such as adjustments of accruals on long-term contracts or write-down or write-off of receivables, inventories, property, plant, and equipment used in the business, equipment leased to others, deferred research and development costs, or other intangible assets. However, such adjustments, costs, and expenses which (a) are clearly a direct result of the decision to dispose of the segment and (b) are clearly not the adjustments of carrying amounts or costs, or expenses that should have been recognized on a going-concern basis prior to the measurement date should be included in determining the gain or loss on disposal. Results of operations before the measurement date should not be included in the gain or loss on disposal.
17. Costs and expenses directly associated with the decision to dispose include items such as severance pay, additional pension costs, employee relocation expenses, and future rentals on long-term leases to the extent they are not offset by sub-lease rentals.

18. Disclosure. In addition to the amounts that should be disclosed in the financial statements (paragraph 8), the notes to financial statements for the period encompassing the measurement date should disclose:

   a. the identity of the segment of business that has been or will be discontinued,
   b. the expected disposal date, if known (see paragraph 14),
   c. the expected manner of disposal,
   d. a description of the remaining assets and liabilities of the segment at the balance sheet date, and
   e. the income or loss from operations and any proceeds from disposal of the segment during the period from the measurement date to the date of the balance sheet.

For periods subsequent to the measurement date and including the period of disposal, notes to the financial statements should disclose the information listed in (a), (b), (c), and (d) above and also the information listed in (e) above compared with the prior estimates.

7 Consideration should be given to disclosing this information by segregation in the balance sheet of the net assets and liabilities (current and noncurrent) of the discontinued segment. Only liabilities which will be assumed by others should be designated as liabilities of the discontinued segment. If the loss on disposal cannot be estimated within reasonable limits, this fact should be disclosed.

20. Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item:

   a. Unusual nature—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates. (See discussion in paragraph 21.)
   b. Infrequency of occurrence—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates. (See discussion in paragraph 22.)

21. Unusual Nature. The specific characteristics of the entity, such as type and scope of operations, lines of business, and operating policies should be considered in determining ordinary and typical activities of an entity. The environment in which an entity operates is a primary consideration in determining whether an underlying event or transaction is abnormal and significantly different from the ordinary and typical activities of the entity. The environment of an entity includes such factors as the characteristics of the industry or industries in which it operates, the geographical location of its operations, and the nature and extent of governmental regulation. Thus, an event or transaction may be unusual in nature for one entity but not for another because of differences in their respective environments. Unusual nature is not established by the fact that an event or transaction is beyond the control of management.

22. Infrequency of Occurrence. For purposes of this Opinion, an event or transaction of a type not reasonably expected to recur in the foreseeable future is considered to occur infrequently. Determining the probability of recurrence of a particular event or transaction in the foreseeable future should take into account the environment in which an entity operates. Accordingly, a specific transaction of one entity might meet that criterion and a similar transaction
of another entity might not because of different probabilities of recurrence. The past occurrence
of an event or transaction for a particular entity provides evidence to assess the probability of
recurrence of that type of event or transaction in the foreseeable future. By definition,
extraordinary items occur infrequently. However, mere infrequency of occurrence of a particular
event or transaction does not alone imply that its effects should be classified as extraordinary. An
event or transaction of a type that occurs frequently in the environment in which the entity
operates cannot, by definition, be considered as extraordinary, regardless of its financial effect.

23. Certain gains and losses should not be reported as extraordinary items because they are
usual in nature or may be expected to recur as a consequence of customary and continuing
business activities. Examples include:

   a. Write down or write-off of receivables, inventories, equipment leased to others,
      deferred research and development costs, or other intangible assets.
   b. Gains or losses from exchange or translation of foreign currencies, including
      those relating to major devaluations and revaluations.
   c. Gains or losses on disposal of a segment of a business.
   d. Other gains or losses from sale or abandonment of property, plant, or equipment
      used in the business.
   e. Effects of a strike, including those against competitors and major suppliers.
   f. Adjustment of accruals on long-term contracts.

In rare situations, an event or transaction may occur that clearly meets both criteria specified in
paragraph 20 of this Opinion and thus gives rise to an extraordinary gain or loss that includes one
or more of the gains or losses enumerated above. In these circumstances, gains or losses such as (a) and (d) above should be included in the extraordinary item if they are a direct result of a
major casualty (such as an earthquake), an expropriation, or a prohibition under a newly enacted
law or regulation that clearly meets both criteria specified in paragraph 20. However, any portion
of such losses which would have resulted from a valuation of assets on a going concern basis
should not be included in the extraordinary items. Disposals of a segment of a business should
be accounted for pursuant to paragraph 13 and presented in the income statement pursuant to
paragraph 8 even though the circumstances of the disposal meet the criteria specified in
paragraph 20.

Adjustment of Amounts Reported in Prior Periods

25. Circumstances attendant to disposals of a segment of a business and extraordinary
items frequently require estimates, for example, of associated costs and occasionally of
associated revenue, based on judgment and evaluation of the facts known at the time of first
accounting for the event. Each adjustment in the current period of a loss on disposal of a
business segment or of an element of an extraordinary item that was reported in a prior period
[should not be reported as a prior period adjustment unless it meets the criteria for a prior period
adjustment as defined in paragraph 23 of APB Opinion No. 9. An adjustment that does not meet
such criteria] should be separately disclosed as to year of origin, nature, and amount and
classified separately in the current period in the same manner as the original item. If the
adjustment is the correction of an error, the provisions of APB Opinion No. 20, Accounting
Changes, paragraphs 36 and 37 should be applied.

Disclosure of Unusual or Infrequently Occurring Items

26. A material event or transaction that is unusual in nature or occurs infrequently but not
both, and therefore does not meet both criteria for classification as an extraordinary item, should
be reported as a separate component of income from continuing operations. The nature and
financial effects of each event or transaction should be disclosed on the face of the income
statement or, alternatively, in notes to the financial statements. Gains or losses of a similar nature
that are not individually material should be aggregated. Such items should not be reported on the
face of the income statement net of income taxes or in any manner inconsistent with the
provisions of paragraphs 8 and 11 of this Opinion or in any other manner that may imply that they
are extraordinary items. Similarly, the earnings per share effects of those items should not be
disclosed on the face of the income statement.8

8 Exceptions to the final two sentences of this paragraph are specified in the following AICPA industry audit
guides: Audits of Banks, p. 36; Audits of Fire and Casualty Insurance Company, p. 66; and Audits of Stock Life
Insurance Companies, p. 89.

20. Note that the bracketed section of APB 30, paragraph 25 was amended by FASB Statement
No. 16, Prior Period Adjustments.

OTHER SOURCES OF INFORMATION

21. The NAIC Technical Resource Group proposed draft life codification, Chapter 28, Unassigned
Surplus, includes the following:

Extraordinary Items

Extraordinary items are events and transactions that are distinguished by their unusual nature
and by the infrequency of their occurrence. Both of the following criteria should be met to classify
an event or transaction as an extraordinary item:

a. Unusual nature - the underlying event or transaction should possess a high degree of
abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and
typical activities of the entity, taking into consideration the environment in which the entity
operates.

b. Infrequency of occurrence - the underlying event or transaction should be of a type that
would not reasonably be expected to recur in the foreseeable future, taking into account the
environment in which the entity operates.

Unusual Nature. The specific characteristics of the entity, such as type and scope of operations,
lines of business, and operating policies should be considered in determining ordinary and typical
activities of an entity. The environment in which an entity operates is a primary consideration in
determining whether an underlying event or transaction is abnormal and significantly different
from the ordinary and typical activities of the entity. The environment of an entity includes such
factors as the characteristics of its products and the geographic location of its operations. Thus,
an event or transaction may be unusual in nature for one entity but not for another because of
differences in their respective environments. Unusual nature is not established by the fact that an
event or transaction is beyond the control of management.

Infrequency of Occurrence. An event or transaction of a type not reasonably expected to recur in
the foreseeable future is considered to occur infrequently. Determining the probability of
recurrence of a particular event or transaction in the foreseeable future should take into account
the environment in which the entity operates. Accordingly, a specific transaction of one entity
might meet that criterion and a similar transaction of another entity might not because of different
probabilities of recurrence. The past occurrence of an event or transaction for a particular entity
provides evidence to assess the probability of recurrence of that type of event or transaction in
the foreseeable future. By definition, extraordinary items occur infrequently. However, mere
infrequency of occurrence of a particular event or transaction does not alone imply that its effects
should be classified as extraordinary. An event or transaction of a type that occurs frequently in
the environment in which the entity operates cannot, by definition, be considered as
extraordinary, regardless of the financial effect.
Materiality. An extraordinary event or transaction, if material, shall be classified separately in the Summary of Operations. Items shall be evaluated individually and not in the aggregate in determining whether an event or transaction is material.

Even though they do not meet the criteria for an extraordinary item, if material, gains and losses from extinguishment of debt, significant asset disposition after a pooling, discontinuation of accounting for the effects of certain types of regulation, shall be classified as an extraordinary item.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 20 - Gain Contingencies

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions
- Accounting Interpretation of Accounting Principles Board Opinion 30, Reporting the Results of Operations
- FASB Emerging Issues Task Force No. 85-36, Discontinued Operations with Expected Gain and Interim Operating Losses
- FASB Emerging Issues Task Force No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)
- FASB Emerging Issues Task Force No. 95-18, Accounting and Reporting for a Discontinued Business Segment When the Measurement Date Occurs after the Balance Sheet Date but before the Issuance of Financial Statements.

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- NAIC Technical Resource Group proposed draft life codification, Chapter 28, Unassigned Surplus
Statutory Issue Paper No. 25

Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties

STATUS
Finalized June 23, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Transactions with affiliates and other related parties are entered into in the ordinary course of business by reporting entities. Transactions may involve an exchange of assets and liabilities between the related parties or the performance of services. Such transactions may not necessarily be on an arm's length basis. Current statutory literature provides guidance on accounting for certain transactions between affiliates, which is based on whether the transactions are considered economic or non-economic transactions. It also requires reporting entities to disclose transactions with affiliates in the notes to the financial statements.

2. GAAP provides limited guidance on accounting for related party transactions, and there is no discussion regarding accounting for economic versus non-economic transactions with related parties. Rather, existing GAAP guidance focuses on disclosure of related party transactions with specific GAAP literature dealing with related party issues where there is a perceived potential for abusive accounting practices (e.g. sale lease-back transactions, equity accounting, nonmonetary transactions, etc.).

3. The purpose of this issue paper is to establish statutory accounting principles and disclosure requirements for related party transactions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Related parties are defined as entities that have common interests as a result of ownership, control, or affiliation or by contract. Related parties shall include but are not limited to the following:

   a. Affiliates of the reporting entity, as defined in paragraph 5;

   b. Trusts for the benefit of employees, such as pension and profit-sharing trusts and Employee Stock Ownership Plans that are managed by or under the trusteeship of management of the reporting entity, its parent or affiliates;

   c. The principal owners of the reporting entity;

   d. The management of the reporting entity, its parent or affiliates (including directors);

   e. Members of the immediate families of principal owners and management of the reporting entity, its parent or affiliates and their management;

   f. Parties with which the reporting entity may deal if either party directly or indirectly controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interest;
g. A party which can directly or indirectly significantly influence the management or operating policies of the reporting entity, which may include a provider who is contracting with the reporting entity. This is not intended to suggest that all provider contracts create related party relationships;

h. A party which has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests;

i. Attorney-in-fact of a reciprocal reporting entity or any affiliate of the attorney-in-fact; and


5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies. An affiliate is any person that is directly or indirectly, owned or controlled by the same person or by the same group of persons, that, directly or indirectly, own or control the reporting entity.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person or entity, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by contract for goods or nonmanagement services where the volume of activity results in a reliance relationship, (d) by common management, or (e) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in a company and a second member of the group has an 8% interest in the same company the total interest is 13%, and therefore, each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Related party transactions are subject to abuses because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny.

Related Party Loans

9. Loans or advances (including debt, public or private) made by a reporting entity to its parent or principal owner shall be admitted if approval for the transaction has been obtained from the domiciliary commissioner and the loan or advance is determined to be collectible based on the parent or principal owner’s independent payment ability. An affiliate’s ability to pay shall be determined after consideration of the liquid assets or revenues available from external sources (i.e. determination shall not include dividend paying ability of the subsidiary making the loan or advance) which are available to repay the balance and/or maintain its account on a current basis. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), it is probable the balance is
uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

10. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 13. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 13 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with Issue Paper No. 5 it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

11. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

12. Indirect loans are loans or extensions of credit to any person who is not an affiliate, where the reporting entity makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the reporting entity making the loans or extensions of credit. The admissibility of indirect loans made by a reporting entity for the benefit of its parent or principal owner shall be determined in accordance with the guidelines in paragraph 9. Indirect loans made for the benefit of all other related parties shall be evaluated and accounted for consistent with loans and advances to related parties as described in paragraphs 10 and 11.

Transactions Involving the Exchange of Assets or Liabilities

13. An arm’s length transaction is defined as a transaction in which willing parties, each being reasonably aware of all relevant facts and neither under compulsion to buy, sell or loan, would be willing to participate. A transaction between related parties involving the exchange of assets or liabilities shall be designated as either an economic transaction or non-economic transaction. An economic transaction shall be defined as an arm's length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. “permanence.” The appearance of permanence is also an important criterion in assessing the economic substance of a transaction. In order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed. If subsequent events or transactions reverse the effect of an earlier transaction prior to the issuance of the financial statements, the reversal shall be considered in determining whether economic substance existed in the case of the original transaction. Subsequent events are addressed in Issue Paper No. 9 - Subsequent Events. An economic transaction must represent a bonafide business purpose demonstrable in measurable terms. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction. The statutory accounting shall follow the substance of the transaction and not the form of the transaction.

14. In determining whether there has been a transfer of the risks and rewards of ownership in the transfer of assets or liabilities between related parties, the following—and any other relevant facts and circumstances related to the transaction—shall be considered:

a. Whether the seller has a continuing involvement in the transaction or in the financial interest transferred, such as through the exercise of managerial authority to a degree usually associated with ownership;

b. Whether there is an absence of significant financial investment by the buyer in the financial interest transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer;
c. Whether repayment of debt that constitutes the principal consideration in the transaction is dependent on the generation of sufficient funds from the asset transferred;

d. Whether limitations or restrictions exist on the buyer’s use of the financial interest transferred or on the profits arising from it;

e. Whether there is retention of effective control of the financial interest by the seller.

15. A transaction between related parties may meet the criteria for treatment as an economic transaction at one level of financial reporting but may not meet such criteria at another level of financial reporting. An example of such a transaction is a reporting entity purchasing securities at market value from an affiliated reporting entity that carried the securities at amortized cost. This transaction meets the criteria of an economic transaction at this level of financial reporting and therefore the selling reporting entity would record a gain and the acquiring reporting entity would record the securities at their cost (market value on the transaction date). At the common parent level of reporting, this transaction has resulted in the mere inflation of surplus, and therefore, is a non-economic transaction. The parent reporting entity shall defer the net effects of any gain or increase in surplus resulting from such transactions by recording a deferred gain and an unrealized loss. The deferred gain shall not be recognized by the parent reporting entity unless and until arms-length transaction(s) with independent third parties give rise to appropriate recognition of the gain.

16. A non-economic transaction shall be defined as any transaction that does not meet the criteria of an economic transaction. Similar to the situation described in paragraph 15, transfers of assets from a parent reporting entity to a subsidiary, controlled or affiliated entity shall be treated as non-economic transactions at the parent reporting level because the parent has continuing indirect involvement in the assets.

17. When accounting for a specific transaction reporting entities shall use the following valuation methods:

a. Economic transactions between related parties shall be recorded at fair value at the date of the transaction. To the extent that the related parties are affiliates under common control, the controlling reporting entity shall defer the effects of such transactions that result in gains or increases in surplus (see paragraph 15);

b. Non-economic transactions between reporting entities, which meet the definition of related parties above, shall be recorded at the lower of existing book values or fair values at the date of the transaction;

c. Non-economic transactions between a reporting entity and an entity that has no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded at the fair value at the date of the transaction; however, to the extent that the transaction results in a gain, that gain shall be deferred until such time as permanence can be verified;

d. Transactions which are designed to avoid statutory accounting practices shall be included as if the reporting entity continued to own the assets or be obligated for a liability directly instead of through a subsidiary.

Examples of transactions that would be deemed to be non-economic include, security swaps of similar issues between or among affiliated companies, and swaps of dissimilar issues accompanied by exchanges of liabilities between or among affiliates.
Transactions Involving Services
18. Transactions involving services being provided by a related party may not be arm’s-length. Amounts charged for services provided may not be at current market rates for such services or may be based on allocations of costs. Determining market rates for services is difficult because the circumstances surrounding each transaction are unique. Unlike transactions involving the exchange of assets and liabilities between related parties, transactions for services create income on one party’s books and expense on the second party’s books and therefore do not lend themselves to the mere inflation of surplus. These arrangements may be subject to regulatory approval.

19. Transactions involving services provided between related parties shall be recorded at the amount charged. Regulatory scrutiny of related party transactions where amounts charged for services do not meet the fair and reasonable standard established by Appendix A-440, may result in (a) amounts charged being recharacterized as dividends or capital contributions, (b) transactions being reversed, (c) receivable balances being nonadmitted, (d) or other regulatory action. Expenses that result from cost allocations shall be allocated subject to the same fair and reasonable standards, and the books and records of each party shall disclose clearly and accurately the precise nature and details of the transaction. See Issue Paper No. 94 - Allocation of Expenses for additional discussion regarding the allocation of expenses.

Disclosure
20. The financial statements shall include disclosures of all material related party transactions. In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed. Transactions shall not be purported to be arm’s length transactions unless there is demonstrable evidence to support such statement. The disclosures shall include:

   a. The nature of the relationships involved;

   b. A description of the transactions for each of the periods for which financial statements are presented, and such other information considered necessary to obtain an understanding of the effects of the transactions on the financial statements. Exclude reinsurance transactions, and any non-insurance transactions which involve less than ½ of 1% of the total admitted assets of the reporting entity, and cost allocation transactions. The following information shall be provided if applicable:

      1. Date of transaction,
      2. Explanation of transaction,
      3. Name of reporting entity,
      4. Name of affiliate,
      5. Description of assets received by reporting entity,
      6. Statement value of assets received by reporting entity,
      7. Description of assets transferred by reporting entity, and
      8. Statement value of assets transferred by reporting entity.

   c. The dollar amounts of transactions for each of the periods for which financial statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period;

   d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement;

   e. Any guarantees or undertakings, written or otherwise, for the benefit of an affiliate or related party which result in a material contingent exposure of the reporting entity’s or any related party’s assets or liabilities;
f. A description of material management or service contracts and cost-sharing arrangements involving the reporting entity and any related party. This shall include, but is not limited to, sale lease-back arrangements, computer or fixed asset leasing arrangements and agency contracts, which remove assets otherwise recordable (and potentially nonadmitted) on the reporting entity’s financial statements;

g. The nature of the control relationship whereby the reporting entity and one or more other enterprises are under common ownership or control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the enterprises were autonomous. The relationship shall be disclosed even though there are no transactions between the enterprises.

h. The amount deducted from the value of an upstream intermediate company or ultimate parent owned, either directly or indirectly, via a downstream subsidiary, controlled, or affiliated company, in accordance with the NAIC Purposes and Procedures of the Securities Valuation Office, “Procedures for Valuing Common Stocks and Stock Warrants.”

**DISCUSSION**

21. This issue paper adopts FASB Statement No. 57, Related Party Disclosures (FAS 57) with a modification to paragraph 2, to require disclosure of compensation arrangements, expense allowances, and other similar items in the ordinary course of business. It expands the current statutory guidance on accounting and disclosure of transactions with affiliates to include all material related party transactions whereas current statutory guidance requires disclosures for transactions with affiliates, a more narrowly defined group. This modification was made because the nature of dealings with any related party can not be assumed to be at arm’s length. The current statutory guidance with respect to accounting for transfers of assets between affiliates that are considered to be non-economic transactions (generally at lower of cost or market) differs from the GAAP guidance for accounting for transfers and exchanges between companies under common control. Current statutory guidance is considered appropriate because of the need to focus on individual reporting entities and the needs of individual states to monitor the obligations of individual reporting entities. GAAP guidance is established in Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control (AIN-APB 16, #39), which requires transfers and exchanges to be at historical cost similar to that in pooling of interests accounting. As a result, this issue paper rejects AIN-APB 16, #39. The complete requirements under current statutory guidance and FAS 57 are included in the Relevant Statutory Accounting and GAAP Guidance section below.

22. This issue paper adopts the current statutory guidance with respect to accounting for transfers of assets between affiliates and further expands that guidance to include all transactions (including transactions which relate to the transfer of liabilities) with related parties. It also replaces the 30 day rule by requiring the reversal of any gain or loss recognized on a transaction that subsequently does not meet the appearance of permanence. This issue paper also requires any net increase in the surplus of a parent reporting entity that results from transactions between affiliates where there is no demonstrable and measurable betterment to the parent company reporting entity other than the mere inflation of surplus to be reported as a deferred gain and shall not be recognized by the parent reporting entity until an arms length transaction with a third party gives rise to the recognition.

23. This issue paper adopts current statutory guidance with modification to recognize loans made to a reporting entity’s parent or principal owner as an admitted asset if regulatory approval for the transaction has been obtained and the loan appears to be collectible based on the parent’s independent ability to pay. Commissioner approval is considered necessary as an additional independent evaluation of such loans or...
advances due to the highly sensitive nature of such transactions and the significant potential for abuse. This independent evaluation is considered necessary to determine the admissibility of such loans or advances because a reporting entity could be induced by its parent or principal owner to enter into a loan or advance that it would not otherwise consider. Additionally, advances to providers under capitation arrangements that exceed one month’s payment shall be nonadmitted. Loans to all other related parties shall be nonadmitted if they do not meet the criteria of an arm’s length transaction. Current statutory accounting requires disclosures to include a description of related party transactions as well as other information necessary to obtain an understanding of the transaction. Subparagraph 20 b amends the exclusion to this requirement from non-insurance transactions which involve less than 1/2% of 1% of the total assets of the largest affiliated reporting entity to non-insurance transactions which involve less than 1/2% of 1% of the total admitted assets of the reporting entity.

24. The accounting and disclosure requirements adopted by the conclusion above are consistent with the Statement of Concepts which states:

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

Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity’s short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g. notes to financial statements, management's discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

25. Additionally, such disclosures provide the statutory financial statement user information necessary in evaluating a reporting entity’s statutory financial position and results of operations and in assessing the reporting entity’s dependence on such relationships to continue operations.

Drafting Notes/Comments
- Accounting for investments in subsidiaries is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Accounting for business combinations is addressed in Issue Paper No. 68 - Business Combinations and Goodwill.
- Accounting for holding company obligations are addressed in Issue Paper No. 95 - Holding Company Obligations.
- Accounting and disclosures for related party reinsurance transactions are addressed in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance and Issue Paper No. 75 - Property and Casualty Reinsurance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
26. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies (Annual Statement Instructions) provide the following guidance with respect to reporting information on transactions with affiliates in the notes to the financial statements:

5. Information Concerning Parent, Subsidiaries and Affiliates

Instruction:

a. If the company is directly or indirectly owned or controlled by any other company, corporation, group of companies, partnership or individual, give full particulars.
b. List and describe transactions by the company or any affiliated insurer with any affiliate. Exclude reinsurance transactions, any non-insurance transactions which involve less than ⅙ of 1% of the total assets of the largest affiliated insurer, and cost allocation transactions that are based upon generally accepted accounting principles. The following information should be provided:

1. Date of transaction
2. Explanation of transaction
3. Name of insurer
4. Name of affiliate
5. Description of assets received by insurer
6. Statement value of assets received by insurer
7. Description of assets transferred by insurer
8. Statement value of assets transferred by insurer

c. If the company holds investments in its parent, affiliates, or subsidiaries, disclose the total statement value for each such asset category not included in Schedule D, Summary By Country.

d. If the Company owns shares of an upstream intermediate or ultimate parent, either directly or indirectly via a downstream subsidiary, controlled or affiliated company, disclose the amount deducted from the value of such company or companies, in accordance with the Purposes and Procedures manual of the Securities Valuation Office of the NAIC.

e. Describe any guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company's or any affiliated insurer's assets to liability, if not disclosed in Note 15. Report the total amount of guarantees for affiliates.

f. Describe management or service contracts and all cost-sharing arrangements, other than cost allocation arrangements based upon generally accepted accounting principles, involving the company or any affiliated insurer.

27. The Annual Statement Instructions provide illustrations for the above required disclosures.

28. The Annual Statement Instructions also require the preparation of Schedule Y - Information Concerning Activities of Insurer Members of a Holding Company Group. Part 2 of this schedule—Summary of Insurer’s Transactions with Any Affiliates—was designed to provide an overview of transactions among holding company system members. A common schedule is prepared for inclusion in each of the individual annual statements and the consolidated annual statement. The intent of the schedule is to demonstrate the scope and direction of major fund and/or surplus flows throughout the holding company system. The instructions to the schedule provide detailed guidance on a column by column basis. This schedule requires additional disclosures that are not required or are in more detail than the information contained in the notes to the financial statements. The instructions for the schedule include the following guidance:

Include the aggregate transactions, for the reporting period, within each category involving the parent company (companies), all insurance companies in the Holding Company System, and all other companies in the system with which an insurance company member had a transaction. Exclude: transactions of a non-insurer with an insurance company that are of a routine nature (i.e., the purchase of insurance coverage) and cost allocation transactions that are based upon generally accepted principles of accounting.

If the insurer is both a payor and a recipient of amounts in any category, the net of these amounts should be reported on one line. Amounts of transactions that result in an increase in surplus should be shown as positive figures and transactions that result in a decrease in surplus should be reported enclosed in parentheses.
If the nature of the transactions reported in Part 2 require explanation, report such in an explanatory note immediately following Part 2.

29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies contain guidance substantially consistent with paragraphs 26 to 28 above.

30. The NAIC Annual Statement Instructions for Health Maintenance Organizations contain guidance substantially consistent with paragraphs 26 to 28 above.

31. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following definition of terms used in connection with transactions with affiliates:

"Arm's-length" Transactions

An “arm's-length” transaction can be defined as a transaction in which a willing buyer and a willing seller, each being reasonably aware of all relevant facts and neither under compulsion to buy or sell, would be willing to participate.

"Affiliate"

An “affiliate” of, or person “affiliated” with a specific person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

"Control"

The term “control” (including the terms “controlling by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies, representing 10% or more of the voting securities of any other person.

32. The Introduction to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies provides the following guidance with respect to accounting for assets transferred between affiliates:

Accounting for Assets Transferred Between Affiliates

Economic vs. Non-economic Gains

An economic transaction is an arm's-length transaction which results in the transfer of risks and rewards of ownership and represents a consummated act thereof, i.e. “permanence.” Such a transaction must represent a bona fide business purpose demonstrable in measurable terms, such as the creation of a tax benefit, a betterment in cash flow position, etc. A transaction which results in the mere inflation of surplus without any other demonstrable and measurable betterment is not an economic transaction.

A bona fide business purpose would exist, for example, if an asset was transferred in order to create a specific advantage/benefit. The advantage/benefit must inure to the benefit of the insurance company. A bona fide business purpose would not exist if the transaction was initiated for the purpose of the inflation (deflation) of a particular company's financial statements including effects on the balance sheet or income statement.

Transfer of risks and rewards of ownership - “determining that the risks and other incidents of ownership have been transferred to the buyer requires an examination of the underlying facts
and circumstances. The following circumstances may raise the question about the transfer of risks:

1. A continuing involvement by the seller in the transaction or in the assets transferred, such as through the exercise of managerial authority to a degree usually associated with ownership, perhaps in the form of a remarketing agreement or a commitment to operate the property.

2. Absence of significant financial investment by the buyer in the asset transferred, as evidenced, for example, by a token down payment or by a concurrent loan to the buyer.

3. Repayment of debt that constitutes the principal consideration in the transaction dependent on the generation of sufficient funds from the asset transferred.

4. Limitations or restrictions on the purchaser's use of the asset transferred or on the profits from it.

5. Retention of effective control of the asset by the seller.

The first three items on the list are suggested by the Securities Exchange Commission Staff Accounting Bulletin 30; the last two are found in SEC Accounting Series Release No. 95, “Accounting for Real Estate Transactions where circumstances indicate that profits were not earned at the time the transactions were recorded”.*


Security swaps of similar issues between or amongst affiliated companies would be considered as a non-economic transaction. Swaps of dissimilar issues accompanied by exchanges of liabilities between or amongst affiliates are considered non-economic transactions.

The appearance of permanence is also an important criterion in establishing the economic substance of a transaction. If subsequent events or transactions reverse the effect of an earlier transaction, the question is raised as to whether economic substance existed in the case of the original transaction. Basically, in order for a transaction to have economic substance and thus warrant revenue (loss) recognition, it must appear unlikely to be reversed.

It is important to note that in today's environment, where many of the transactions are complex and involve great uncertainty, it will be necessary to exercise professional judgment in the evaluation of whether economic substance exists as it is not possible to establish detailed guidelines sufficient to cover the realm of all possible transactions.

In the case of any gain from transfer of securities or other assets to an affiliate where it appears that, within a period beginning 30 days before the date of such transfer and ending 30 days after such date, the company has acquired by transfer from an affiliate, or has entered into a contract or option to acquire, substantially identical securities or assets, then no gain on the transfer to the affiliate shall be recognized in the Annual Statement.

The following is the exception to the 30-day rule:

1. Swaps of repurchased securities. The agreements must be formalized in writing and provide adequate collateral as defined by either statute or security valuation manual.

2. Gains on transfers which involve real estate will not be recognized if transferred back or repurchased within an 18-month period.
General Accounting Guidelines

When accounting for a specific transaction, the following valuation methods should be used. If the transaction involves the transfer of assets not covered by the attached [table] then the following general guidelines should be used:

- Economic based transfers between affiliates should be recorded at prevailing fair market values at the date of the transfer.
- Non-economic based transfers between affiliated insurers should be recorded at the lower of existing book values or prevailing fair market values at the date of transfer.
- Non-economic based transfers between an insurer and a non-insurance affiliate should be recorded at the prevailing fair market value at the date of transfer; however, to the extent that the transfer results in a gain, that gain should be deferred until such time as permanence can be verified.
- Transactions which are designed to avoid statutory accounting practices shall be included as if the insurer continued to own the assets directly instead of through a subsidiary. Therefore, the assets of a subsidiary will be valued as they would constitute lawful investments for the insurer if acquired or held by the insurer. (e.g., transaction dealing with agents’ balances, furniture and equipment.)
- Assets may be valued on a different basis if held by a life insurer versus a property and casualty insurer; therefore, a regulator must take this into consideration when using the general guidelines.
- In the absence of specific guidelines or where doubt exists as to the propriety of a special accounting method the Insurance Department of the state of domicile should be consulted.

<table>
<thead>
<tr>
<th>TRANSACTION</th>
<th>NON-ECONOMIC AFFILIATE</th>
<th>ECONOMIC TRANSACTION</th>
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<td><strong>1. Transfer of Bonds</strong></td>
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<td>a. Appreciated</td>
<td>Cost (1)/Amortized</td>
<td>Market</td>
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<tr>
<td>b. Depreciated</td>
<td>LCM (1)</td>
<td>Market</td>
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<tr>
<td>a. Sinking Fund</td>
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<td>c. All others</td>
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<tr>
<td><strong>3. Transfer of Common Stock</strong></td>
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<tr>
<td>a. Appreciated</td>
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<td>b. Depreciated</td>
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<tr>
<td><strong>8. Reverse Repurchase Agreements</strong></td>
<td>LCM (2)</td>
<td>Market (2)</td>
</tr>
</tbody>
</table>
9. **Transfer of nonadmitted assets from an insurer to a non-insurer subsidiary**
   The value of the subsidiary must be adjusted and revalued as if the insurer held the assets.

10. **Transfer of Schedule BA asset**
    LCM Market

**NOTE:** Cost = Book Value

   (1) Assumes securities are in good standing or eligible for amortization, otherwise at market.
   (2) Based on current market interest rates.
   (3) LCM (Lower of Cost or Market) would apply under scenario involving depreciated assets.

33. The Insurance Holding Company System Model Laws, Regulations and Guidelines, which has been adopted by various states, specifies that certain disclosures be made in Form B of an insurer’s registration statement (insurers required to file registration statements with the NAIC do so on the format prescribed by the NAIC). Form B instructions are as follows:

**ITEM 5. TRANSACTIONS AND AGREEMENTS**

Briefly describe the following agreements in force, and transactions currently outstanding or which have occurred during the last calendar year between the registrant and its affiliates:

   a. Loans, other investments, or purchases, sales or exchanges of securities of the affiliates by the Registrant or of the Registrant by its affiliates;
   b. Purchases, sales or exchanges of assets;
   c. Transactions not in the ordinary course of business;
   d. Guarantees or undertakings for the benefit of an affiliate which result in an actual contingent exposure of the Registrant's assets to liability, other than insurance contracts entered into in the ordinary course of the registrant's business;
   e. All management agreements, service contracts and all cost-sharing arrangements;
   f. Reinsurance agreements;
   g. Dividends and other distributions to shareholders;
   h. Consolidated tax allocation agreements; and
   i. Any pledge of the registrant's stock and/or of the stock of any subsidiary or controlling affiliate, for a loan made to any member of the insurance holding company system.

No information need be disclosed if such information is not material for purposes of Section 4 of the Act.

Sales, purchases, exchanges, loans or extensions of credit, investments or guarantees involving one-half of 1% or less of the registrant's admitted assets as of the 31st day of December next preceding shall not be deemed material.

**Note:** Commissioner may by rule, regulation or order provide otherwise.

The description shall be in a manner as to permit the proper evaluation thereof by the Commissioner, and shall include at least the following: the nature and purpose of the transaction, the nature and amounts of any payments or transfers of assets between the parties, the identity of all parties to the transaction, and relationship of the affiliated parties to the registrant.

34. Section 5 of the Insurance Holding Company System Regulatory Act also contains the following guidance:
The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.

(a) Sales, purchases, exchanges, loans, extensions of credit, or investments, provided the transactions are equal to or exceed:

(i) With respect to nonlife insurers, the lesser of three percent (3%) of the insurer’s admitted assets or twenty-five percent (25%) of surplus as regards policyholders as of the 31st day of December next preceding;

(ii) With respect to life insurers, three percent (3%) of the insurer’s admitted assets as of the 31st day of December next preceding;

(b) Loans or extensions of credit to any person who is not an affiliate, where the insurer makes loans or extensions of credit with the agreement or understanding that the proceeds of the transactions, in whole or in substantial part, are to be used to make loans or extensions of credit to, to purchase assets of, or to make investments in, any affiliate of the insurer making the loans or extensions of credit.

35. The NAIC Model Law for HMO Investment Guidelines, contains the following:

Section 3. Excessive Commissions Prohibited—Interest of Officers and Directors.

(2) No such HMO shall knowingly invest in or loan upon any property, directly or indirectly, whether real or personal, in which any officer or director of such HMO has a financial interest, nor shall any such HMO make a loan of any kind to any officer or director of such HMO, except that this Section shall not apply in circumstances where the financial interest of such officer or director is only nominal, trifling or so remote as not to give rise to a conflict of interest. In any case, the Director may approve a transaction between an HMO and its officers or directors under this Section if he is satisfied that (a) the transaction is entered into in good faith for the advantage and benefit of the company, and (b) the amount of the proposed investment or loan does not violate any other provision of this Article nor exceed the reasonable, normal value of the property or the interest which the HMO proposed to acquire, and that the transaction is otherwise fair and reasonable, and (c) the transaction will not adversely affect, to any substantial degree, the liquidity of the company’s investments or its ability thereafter to comply with requirements of this Article or the payment of its claims and obligations.

36. The NAIC Financial Condition Examiners Handbook, Section I, Part IV, Conducting Examinations, contains the following guidance:

a. Affiliates Defined

Affiliates exist when there is a relationship that offers the potential for self-dealing, transactions at less than arm’s length, favorable treatment, or the ability to direct the outcome of events differently from what might result in the absence of that relationship.

Some examples of affiliates are:

- A company’s affiliates
- Principal owners
- Management (including directors)
- Entities for which investments are accounted for by the equity method
• Pension and profit-sharing trusts managed by or under the trusteeship of management

An affiliate also includes any other person with which the reporting entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. A third person also is affiliated if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

b. Affiliated Transactions Defined

An affiliated transaction is any direct or indirect transaction between the reporting entity and an affiliate. Affiliated Transactions include transactions between:

• A parent company and its subsidiaries
• Subsidiaries of a common parent
• The reporting entity and:
  (1) Other affiliated businesses
  (2) Management (including directors)
  (3) Principal owners
  (4) Pension and profit-sharing trusts managed by or under the trusteeship of management
  (5) Other parties having the ability to exert significant influence

Generally Accepted Accounting Principles

37. FAS 57 provides the following guidance:

INTRODUCTION

1. The FASB has been asked to provide guidance on disclosures of transactions between related parties.¹ Examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; (c) an enterprise and trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of the enterprise's management; (d) an enterprise and its principal owners, management, or members of their immediate families; and (e) affiliates. Transactions between related parties commonly occur in the normal course of business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property; services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowings and lendings; guarantees; maintenance of bank balances as compensating balances for the benefit of another; intercompany billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.

¹ Terms defined in the glossary (Appendix B) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Disclosures
2. Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:

2 The requirements of this Statement are applicable to separate financial statements of each or combined groups of each of the following: a parent company, a subsidiary, a corporate joint venture, or a 50-percent-or-less owned investee. However, it is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another enterprise (the primary reporting enterprise) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

3 In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

38. For purposes of FAS 57, certain terms are defined as follows:

a. Affiliate. A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an enterprise.

b. Control. The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.

c. Immediate family. Family members whom a principal owner or a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
d. Management. Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.

e. Principal owners. Owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise.

f. Related parties. Affiliates of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

39. GAAP literature acknowledges the basic problem of when to use predecessor basis vs. fair value or exchange price in accounting for transfers of noncash assets between related parties. Guidance on accounting for transfers of assets between affiliated companies includes the discussion section of EITF 85-21. This indicates that the SEC staff require transfers of assets between companies under common control or between a parent and its subsidiary be valued at their historical cost in the separate statements of each entity that is a party to the transaction. These views relate primarily to transfers of net assets (as in a business combination) or long-lived assets. The form of consideration, whether cash or other, does not change the method of accounting. Any excess paid over the historical cost is treated as a reduction of equity. Certain excerpts follows:

The SEC Observer stated that the SEC staff's views on carrying over historical cost to record, in the separate financial statements of each entity, transfers between companies under common control or between a parent and its subsidiary run primarily to transfers of net assets (as in a business combination) or long-lived assets. Those views would not normally apply to recurring transactions for which valuation is not in question (such as routine transfers of inventory) in the separate financial statements of each entity that is a party to the transaction.

The Task Force members were not in agreement as to whether new basis accounting is acceptable for privately held companies. One Task Force member indicated that the authoritative literature could be read to support the practice. One Task Force member indicated that a concept of the reporting entity would be helpful. Some Task Force members indicated a need for FASB guidance.

40. EITF 84-39 discusses the transfer of monetary and nonmonetary assets among individuals and entities under common control. Certain excerpts follow:

ISSUE
When an asset (for example, real estate) is transferred from an individual to a corporation controlled by that individual in exchange for cash of stock, should the corporation record the transferred property at its fair value at the date of transfer or at its cost to the individual.
EITF DISCUSSION
The Task Force did not reach a consensus on this issue.

Task Force members noted that diversity in practice in certain specific types of transactions, with some members starting from a presumption that carrying amounts should be adjusted to fair value at the date of transfer, while others preferred no change in carrying amount until an asset leaves the controlled group.

41. Accounting Interpretations of APB Opinion No. 16 (AIN-APB 16, #39) discusses transfers and exchanges between companies under common control:

Question - Paragraph 5 of APB Opinion No. 16 states the Opinion does not apply to a transfer of net assets or to an exchange of shares between companies under common control. What are some examples of the types of transactions excluded from the Opinion by this provision and what accounting should be applied?

Interpretation - In general, paragraph 5 excludes transfers and exchanges that do not involve outsiders. For example, a parent company may transfer the net assets of a wholly owned subsidiary into the parent company and liquidate the subsidiary, which is a change in legal organization but not a change in the entity. Likewise, a parent may transfer its interest in several partially owned subsidiaries to a new wholly owned subsidiary, which is again a change in legal organization but not in the entity. Also, a parent may exchange its ownership or the net assets of a wholly owned subsidiary for additional shares issued by the parent's partially owned subsidiary, thereby increasing the parent's percentage of ownership in the partially owned subsidiary but leaving all of the existing minority interest outstanding.

None of the above transfers or exchanges is covered by APB Opinion No. 16. The assets and liabilities so transferred would be accounted for at historical cost in a manner similar to that in pooling of interests accounting.

It should be noted, however, that purchase accounting applies when the effect of a transfer or exchange is to acquire all or part of the outstanding shares held by the minority interest of a subsidiary (see paragraph 43). The acquisition of all or part of a minority interest, however acquired, is never considered a transfer or exchange by companies under common control. (See Interpretation No. 26 of APB No. 16, "Acquisition of Minority Interest." )

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule Y
- NAIC Annual Statement Instructions for Health Maintenance Organizations, Notes to Financial Statements and Schedule Y
- Insurance Holding Company System Model Regulation with Reporting Forms and Instructions, Form B
- Insurance Holding Company System Regulatory Act
- Model Law for HMO Investment Guidelines
- NAIC Financial Condition Examiners Handbook, Section I, Part IV, Conducting Examinations
Generally Accepted Accounting Principles
- FASB Statement No. 57, Related Party Disclosures
- EITF 84-39, Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control (Not a consensus opinion)
- EITF 85-21, Changes of Ownership Resulting in a New Basis of Accounting (Not a consensus opinion)
- Accounting Interpretations of APB Opinion No. 16, #39, Transfers and Exchanges Between Companies Under Common Control

State Regulations
- Wisconsin Administrative Code Ins. 3.50
Statutory Issue Paper No. 26

Bonds, excluding Loan-backed and Structured Securities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for bonds is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC's Securities Valuation Office (SVO) as an authority for the valuation of bonds.

2. The purpose of this paper is to establish statutory accounting principles for bonds, excluding loan-backed and structured securities (which are covered in Issue Paper No. 43 - Loan-backed and Structured Securities (Issue Paper No. 43)) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, bank participations, convertible debt, certificates of deposit and commercial paper that have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. Loan-backed and structured securities meet this definition, but are excluded from the scope of this issue paper, and are addressed in Issue Paper No. 43. Securities which meet the definition above, but have a maturity date of one year or less from the date of acquisition are addressed in Issue Paper No. 28 - Short-term Investments. Mortgage loans and other real estate lending activities made in the ordinary course of business meet the definition above, but are not addressed in this issue paper. These types of transactions are addressed in issue papers 37 and 39.

4. Bonds meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets, and are admitted assets to the extent they conform to the requirements of this paper.

Acquisitions and Sales

5. A bond acquisition or disposal shall be recorded on the trade date, not the settlement date except for the acquisition of private placement bonds which shall be recorded on the funding date. At acquisition, bonds shall be reported at their cost, including brokerage and other related fees, which cannot exceed the fair market value at the date of acquisition.

6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of bonds shall be in accordance with Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses on sales of bonds shall be recorded on the trade date, and shall be reported on the net realized capital gains or losses line of the Investment Income section of the Underwriting and Investment Exhibit.
Amortized Cost
7. Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer’s discretion) shall be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst).

Balance Sheet Amount
8. Bonds shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office (Valuations of Securities manual). For reporting entities that maintain an Asset Valuation Reserve (AVR), the bonds shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or fair market value. For reporting entities that do not maintain an AVR, bonds that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; all other bonds (NAIC designations 3 to 6) shall be reported at the lower of amortized cost or fair market value.

Impairment
9. If it is determined that a decline in the fair market value of a bond is other than temporary, the cost basis of the bond shall be written down to fair market value as a new cost basis and the amount of the write down shall be accounted for as a realized loss. The new cost basis shall not be changed for subsequent recoveries in fair market value. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition. A decline in fair market value which is other than temporary includes situations where a reporting entity has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost). This is consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

Income
10. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual. In accordance with Issue Paper No. 34 - Investment Income Due and Accrued, investment income shall be reduced for amounts which have been determined to be uncollectible. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

11. A bond may provide for a prepayment penalty or acceleration fee in the event the bond is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Origination Fees
12. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction such as the private placement of bonds. The fees include, but are not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the bond consistent with paragraph 7 of this issue paper. Other origination fees shall be recorded in income immediately.
**Origination, Acquisition, and Commitment Costs**

13. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the bond, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase or commitment to purchase bonds shall be charged to expense when incurred.

**Commitment Fees**

14. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the bond is issued. If the bond is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 7 of this issue paper over the life of the bond as an adjustment to the investment income on the bond. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

**Loaned Bonds**

15. When bonds are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the bonds. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned bonds/securities.

**Wash Sales**

16. When a bond is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 19. Unless there is a concurrent contract to repurchase or redeem the transferred bond from the transferee, the transferor does not maintain effective control over the bond.

17. For the securities to be substantially the same, the criteria set forth in paragraph 28 of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) must be met.

**Exchanges and Conversions**

18. If a bond is exchanged or converted into other securities, the fair value of the bond surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the bond surrendered then it shall become the cost basis for the new securities. This is consistent with Issue Paper No. 73 - Nonmonetary Transactions.

**Disclosures**

19. The following disclosures shall be made for bonds in the notes to the financial statements:

- Fair values in accordance with Issue Paper No. 33 - Disclosures about Fair Value of Financial Instruments;
- Concentrations of credit risk in accordance with Issue Paper No. 27 - Disclosures of Information about Financial Instruments with Concentrations of Credit Risk;
- The basis at which the bonds are stated;
- Amortization method;
  Description of any loaned bonds, including the amount, description of the collateral and whether or not the collateral is restricted;
- Reporting entities shall disclose the following information for wash sales, as defined in paragraph 16, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
  a. A description of the reporting entity’s objectives regarding these transactions;
  b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
  c. The number of transactions involved during the reporting period;
  d. The book value of securities sold;
  e. The cost of securities repurchased;
  f. The realized gains/losses associated with the securities involved.

DISCUSSION

20. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for bonds, except as follows:

- Paragraphs 5 and 6 require bond acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

- Paragraph 9 contains an impairment test that is not contained in the current statutory guidance, but which is considered consistent with the conservatism concept in the Statement of Concepts.

- Paragraph 11 requires that prepayment penalties and acceleration fees received from the liquidation of an investment prior to its maturity date be recorded as investment income. Current statutory accounting guidance allows for prepayment penalties and acceleration fees to be recorded as either capital gains or investment income.

- Paragraph 16 provides guidance on sales and subsequent repurchases of bonds which is intended to prevent “window dressing.”

21. This issue paper adopts AICPA Statement of Position 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets and AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps. This issue paper rejects the GAAP guidance for debt securities, which is contained in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FAS 91), FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA, and FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

- FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders’ equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.
- GAAP does not require reporting of AVR or IMR and requires that realized gains and losses be included in income when realized.

- FAS 91 generally requires amortization of the security premium or discount over the remaining life of the security.

- FAS 91 allows deferral of certain origination costs.

22. This paper is consistent with Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (Issue Paper No. 45), in defining what criteria must be met in order for securities to be considered substantially the same. Issue Paper No. 45 adopts paragraph 28 of FAS 125 and AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3).

23. The statutory accounting principles established in this issue paper, attempt to smooth the effect upon a reporting entity’s surplus of fair market value fluctuation of investments held by the reporting entity. This is consistent with the Statement of Concepts which states “conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results.” Statutory accounting principles for life insurance companies also use the concept of AVR and IMR adjustments to compensate for fair market value fluctuations over time.

Drafting Notes/Comments
- Loan-backed and structured securities are addressed in Issue Paper No. 43 - Loan-backed and Structured Securities.
- Repurchase and reverse repurchase agreements are addressed in Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.
- AVR and IMR are addressed in Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve.
- Short-term investments are addressed in Issue Paper No. 28 - Short-term Investments.
- The value of a CMO special purpose subsidiary is addressed in Issue Paper No. 86 - Securitization.
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due and Accrued.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities, states:

Bonds are obligations issued by business units, governmental units, and certain nonprofit units, and having a fixed schedule for one or more future payments of money. This definition includes commercial paper, negotiable certificates of deposit, repurchase agreements, collateralized mortgage obligations (CMOs), mortgage participation certificates (MPCs), interest-only and principal-only certificates (IOs and POs), and equipment trust certificates. Governmental bonds may be classified as general obligation bonds secured by revenue from a restricted source. Corporate bonds are either secured by a claim to mortgage assets or other specific collateral, or by the general credit of the corporation, i.e., debentures. Such investments may be public issues or private placements. Bonds held for investment generate interest income to the investor. Their sale may result in capital gain or loss.
Bonds that pay interest at a rate greater than that which the market requires of similarly rated securities will sell at a “premium” above the face amount of the bond. Bonds with interest rates below the current market will sell at a “discount” from the face amount.

Authorizations and Limitations

Bonds may be subject to qualitative limitations determined by state regulations. For example, a U.S. Treasury Note may have no investment limitations while a railroad bond may have stringent restrictions, both individual (one particular railroad corporation) and in the aggregate (all railroad bonds).

Valuation

Bonds are generally valued at cost adjusted, i.e., amortized, to bring the value to par at maturity. Except for privately placed issues, cost cannot exceed the market value at the date of acquisition, including brokerage and other related fees. Carrying value should not exceed the call price for any particular issue.

Most bond holdings are subject to amortization under the valuation standards of the National Association of Insurance Commissioners and are to be carried at amortized cost. Bonds that do not qualify for amortization according to the NAIC Valuations of Securities manual are to be carried at the value contained in the manual or at book value, whichever is lower. Bonds not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be justified to the appropriate regulatory agency.

The Valuation of Securities Task Force has classified bonds into six categories according to whether the bond can be amortized for establishing the investment value to be used in financial statements. A complete description of the NAIC's classification system, valuation bases to be applied, and the requirements and tests used in the classification of bonds may be obtained by reference to the Valuations of Securities manual, produced by the NAIC.

Most regulatory agencies reserve the privilege of directing the valuation of a specific obligation either not listed in the Valuations of Securities manual or affected by a material financial disclosure subsequent to the annual publication. Investments in foreign securities are accounted for in much the same manner. Procedures for valuation and conversion into U.S. currency are prescribed in the Valuations of Securities manual.

Nonadmitted Bonds

Bond classification as admitted assets varies at the discretion of the states. A bond may be classified as a nonadmitted asset to the extent that it fails a qualitative or quantitative limitation test or is otherwise unauthorized as outlined by the applicable state code. A certain percentage of such investments otherwise not qualifying for investment is commonly permitted by the state codes under a blanket clause or "basket provision" limiting the total quantity of these and other similar investments as a function of net admitted assets or surplus, or both.

For bonds not eligible for amortization, the difference between the amortized (book) value and the association (market) value is treated as a nonadmitted asset.

Premium and Discount

On acquisition, bonds are recorded in the general ledger at their cost. For bonds purchased at a premium, there is to be an annual amortization to reduce the recorded cost to par value. In the case of a bond with a call privilege, the amortized value used should be the lowest value produced by using the maturity date or the call features. The annual amortization of premium is normally accounted for as reduction to interest that has been collected during the year.
For bonds purchased at a discount, where cost is less than par value, there is to be an annual accrual of this discount to increase the ledger value to par value at maturity. The annual accrual of discount is generally accounted for as an addition to interest that has been collected during the year.

For bonds secured by U.S. governmental entities, amortization of premium and accrual of discount may require special handling, and the Valuations of Securities manual should be consulted.

Interest Income

If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.

Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In may respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Commitment and Other Origination Fees

Commitment and other origination fees may arise from the private placement of bonds. Commitment fees are charged by the company to the borrower for promising to make available funds for future borrowing at currently specified interest rates. If the fee is not returnable to the borrower and the bond is not issued, the fee should be taken into income immediately. If the fee is returnable only if the bond is issued, it should not be considered income until it is determined that the bond will not be placed. If it is determined that the bond will be issued, the fee should be deferred and amortized using the interest method over the life of the loan. Other fees intended to compensate the company for interest rate risks associated with the commitment may be built into the interest rates specified and thus, if collected, would be amortized into income over the term of the bond.

Fees charged to borrowers for providing services related to the origination of a private placement should be taken into income immediately only if no portion of the loan is retained by the company. Otherwise, recognition of any fees related to the portion of the loan retained for investment purposes should be deferred until issue and amortized into income using the interest method over the life of the loan. Deferred fee income related to loans originated and retained for resale should be recognized upon sale.

Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements

Where the state of domicile permits such activity, bonds may be loaned or placed under reverse repurchase arrangements with authorized brokers or dealers in securities.

When a bond is loaned, collateral consisting of cash and/or cash equivalent is pledged. The pledged collateral is maintained in an escrow account. The statement will continue to report the insurance company as owner of the bond.

The valuation of this bond will remain unaffected by the loan as long as the amount of the collateral is at least equal to the required amount specified in the Valuations of Securities manual. Failure to hold sufficient collateral may result in the admitted asset value being decreased.

26. The *Purposes and Procedures of the Securities Valuation Office of the NAIC* contains the following guidance:

(B) Corporate Bonds--General Procedure. The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.

(1) Issuers That Have Securities Rated by Other Recognized Rating Agencies or Organizations.

Ratings of other recognized rating organizations will be translated directly into an NAIC Designation. The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade. If there are multiple differing ratings the SVO may use the highest rating but may also go lower where indicated. Where one issue of an issuer has a rating, this rating will be used as a benchmark in determining the ratings of other non-rated issues of the same issuer.

A list of the approved agencies and the translation of their ratings into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must submit to the NAIC's Securities Valuation Office proof that it has been designated a "Nationally Recognized Statistical Rating Organization" (NRSRO) by the Securities and Exchange Commission (SEC) of the Government of the United States of America. Such proof will be acceptable to the NAIC for designation as an NAIC approved rating organization. Rating organizations not so recognized by the SEC may be used by the SVO in its day to day operation when rated entities are not rated by an NAIC approved NRSRO and the quality of such ratings is determined to be substantially similar in quality to those of an NAIC approved NRSRO by SVO staff. The SVO may request whatever documentation deemed necessary to make such a determination. Such rating organizations will not, however, be granted NAIC approved rating organization status.

(2) Issuers of Securities That are Not Rated by Any Other Recognized Rating Organization.

The analysis to determine an NAIC Designation will generally be made up of three segments.

(1) The SVO will apply a quantitative financial model to current and past financial statement data to determine a preliminary measure of the relative financial soundness of the issuer. The result should be expressed as a numeric score which can be ranked against other similar scores and these then related to the various NAIC Designations. It is important to emphasize that the result obtained from the model will not be the sole determinant of an NAIC Designation which determination will be subject to the second and third parts of the analysis which follow.

(2) In the second segment of its analysis the SVO staff will review five years of historical financial data (when available), and any projected data made available to it. This review will cover the balance sheet, the income statement, and the statement of cash flows as obtained from the issuer's financial statements as well as the notes thereto. The staff will also review various standard financial ratios. In addition, the analyst will review the auditors opinion. Furthermore, the SVO analyst is expected to review any news media articles relating to the issuer or research reports that are available. The analysis would also include but is not limited to, a detailed review of the issuer's industry and operating environment as
well as the issuer's management/sponsorship, marketing capabilities, and cost structure to determine the extent of the issuer's competitive edge, if any. These characteristics, when viewed in context with the issuer's financial profile, will determine the ability of the company to respond to varying economic scenarios.

The result of the first two foregoing steps will be a judgment by the SVO analyst of the issuer's implied senior unsecured debt paying ability or rating expressed as an NAIC Designation. The ratings of all other securities of the same issuer (including preferred stocks) can be scaled either upwards or downwards based on that securities' relationship to senior unsecured debt in the capital structure as well as the strength of the credit.

(3) The final part of the analysis will focus on factors that are specific to the security under review as opposed to those relevant to the issuer. This will include a review of:

(a) Covenants
(b) Structure
(c) Collateral
(d) Third party financial support or other credit enhancements
(e) Any other factor specific to the security under review

At all times during the analysis the SVO analyst will have complete discretion to extend the investigation to whatever extent deemed necessary in order to arrive at an appropriate NAIC Designation

(C) Corporate Bonds--Special Factors. All bonds of the following types will be subject to the review procedures of Section 2(B), but the following special factors and statement value considerations will be addressed additionally as indicated.

(1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.

(2) Income Bonds that have paid contingent interest in full for the three most recent years and otherwise meeting the standards of review of Section 2(B) shall be valued on the Annual Statement at amortized cost. The method of amortization shall be straight line. Income bonds not meeting these requirements shall be valued on the Annual Statement at market value.

(3) Perpetual Bonds and Demand Notes not in default and otherwise meeting the requirements of Section 2(B) shall be valued on the Annual Statement at original cost by those insurers maintaining an AVR (see Section 6). All other insurers must value these bonds at market value. Any such bond or note will have its normal NAIC Designation followed by the letter C if the security is eligible for cost treatment.

(4) Church Bonds secured by a mortgage on the church property will have an NAIC Designation determined based on the requirements of Section 2(B) and the appraised value of such property. All others will be reviewed on the basis of sufficient cash flow to meet obligations as they mature.

(5) Oil and Gas Loans. Loans made on the basis of collateralized oil and gas revenues will be reviewed taking into account a reputable petroleum engineer's or geologist's estimates of existing reserves and the related oil and gas pay out and loan payment schedules.
(6) Equipment Trust Certificates will be reviewed first on the basis of an annually submitted SVO collateral valuation form and if that is not submitted then on the credit standing of the certificate issuer.

(7) Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).

(8) Repurchase Agreements. Securities subject to repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B).

(9) Reverse Repurchase Agreements. Securities subject to reverse repurchase agreements will have an NAIC Designation determined in accordance with Section 2(B) if the cash and/or cash equivalents pledged as collateral is equal to 100% or more of the market value of the financed securities as of the date of the statement. If other than identical securities are returned, the transaction is to be treated as an ordinary purchase and sale.

(10) Commercial Paper will be valued under the general procedures of Section 2(B).

(11) Convertible Bonds. Bonds eligible for amortized value will be so valued while bonds not eligible will be valued at the lower of market value or the then existing amortized value.

(12) New Enterprises created either as startup companies or as business combinations of pre-existing business units will be evaluated on the basis of projected income statements and balance sheets since prior figures are either not available or not meaningful. Insurers must submit such projections in order to justify ratings higher than the lowest quality category.

(13) Loaned Securities. Where permitted by an insurer's state of domicile, bonds loaned to others shall be valued in accordance with Section 2(B) if (i) Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and (ii) except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned bonds. In the event that foreign bonds are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign bonds, the amount of Acceptable Collateral that shall be pledged shall be an amount equal to 105% of the market value of the loaned bonds. A decline in value of the acceptable collateral or an increase in the value of the loaned bonds during the term of the loan shall not result in the disqualification from valuation in accordance with Section 2(B) if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned bonds (or 102% of the market value of the loaned bonds if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% and 105%, respectively. For purposes of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall also include securities issued by the U.S. Government or its agencies. The market value of loaned bonds shall include accrued interest on such loaned bonds. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

(14) Debtor in Possession (DIP) Financing. Such financing will not be considered to be equivalent to the prior existing debt of a bankrupt and reorganizing entity. Instead it will be considered for valuation based on its superior claim position,
Bonds, excluding Loan-backed and Structured Securities

(15) Bonds of Liquidating Corporations. Securities of such entities will be marked to market by all insurers and accorded on NAIC rating of "6". In the absence of an active market or a reliable quotation, the value of such securities will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO.

(16) Distressed Bonds trading at less than 25% of par at the date of valuation and which are not original issue deep discount bonds. Such securities will be marked to market by all insurers regardless of whether they are current as to all contractual provisions at the date of valuation.

(17) Pricing of Privately Placed and Illiquid Publicly Traded Bonds In or Near Default. The pricing of privately placed and illiquid publicly traded bonds will be analytically determined by the SVO staff, or the SVO, at its discretion, may accept a value determined by an independent organization approved by the SVO. The pricing of these securities will be dependent on three primary factors:

1. The ultimate recovery value in cents per dollar of par value expected to be received net of all reasonable costs of a workout or bankruptcy proceeding such as fees for accountants, lawyers, bankers, etc.
2. The expected timing of the receipt of such recovery value
3. A discount rate to be applied to factors one and two that reflects market rates of discount for defaulted bonds in general adjusted for the current degree of uncertainty existing in the recovery amount.

Four states of recovery are generally recognized by the SVO and different discount rates reflecting more or less uncertainty will be used for securities in each state. These rates will vary with market conditions. The states are:

(a) Newly defaulted bonds where maximum uncertainty as to recovery exists.
(b) Defaulted securities where a preliminary plan of reorganization has been put forth for discussion.
(c) Defaulted securities where a generally agreed to but unsigned plan is on the table.
(d) Defaulted securities where a plan has been agreed to by all parties and a payout date has been set. This is the only case in which estimated value close to 100% of par will be achievable.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).
(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

<table>
<thead>
<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>AMORTIZED OR INVESTMENT VALUE COLUMN</th>
<th>MARKET VALUE COLUMNS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SVO</td>
<td>Rate</td>
</tr>
<tr>
<td></td>
<td>Market</td>
<td>Par Value X Rate</td>
</tr>
<tr>
<td></td>
<td>Amortized Cost if shown</td>
<td>Amortized Cost</td>
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<tr>
<td></td>
<td>or</td>
<td>Amortized Cost if No Rate</td>
</tr>
<tr>
<td></td>
<td>A.V.</td>
<td>Available</td>
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<tr>
<td></td>
<td>if No Rate</td>
<td>Lower of</td>
</tr>
<tr>
<td></td>
<td>Market Value Amount</td>
<td>Amortized Cost or</td>
</tr>
<tr>
<td></td>
<td>or Amortized Cost</td>
<td>Par Value times</td>
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<tr>
<td></td>
<td>Manual</td>
<td>Market Rate</td>
</tr>
</tbody>
</table>

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

<table>
<thead>
<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>AMORTIZED OR INVESTMENT VALUE COLUMN</th>
<th>MARKET VALUE COLUMNS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SVO</td>
<td>Rate</td>
</tr>
<tr>
<td></td>
<td>Market</td>
<td>Par Value X Rate</td>
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<tr>
<td></td>
<td>if shown</td>
<td>Lower of</td>
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<tr>
<td></td>
<td>A.V.</td>
<td>Cost or Par Value</td>
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<td></td>
<td>if X Rate</td>
<td></td>
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<tr>
<td></td>
<td>Market Value Amount</td>
<td>No Lower of Amortized</td>
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<tr>
<td></td>
<td>or the Amortized Cost</td>
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<tr>
<td></td>
<td>Rate</td>
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<td>VOS</td>
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<tr>
<td></td>
<td>Manual</td>
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<td></td>
<td>X Rate</td>
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</tbody>
</table>

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

27. The NAIC Annual Statement Instructions require that the notes to the financial statements of the Annual Statements include the following information to be disclosed about invested assets:
2. **Basis of Valuation of Invested Assets**

   a. Provide a statement of the valuation basis for invested assets, including bonds, stocks, derivative instruments, etc. State the method of amortization of bonds not backed by other loans, loan-backed bonds and structured securities.

**Generally Accepted Accounting Principles**

28. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

**Accounting for Certain Investments in Debt and Equity Securities**

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

**Held-to-Maturity Securities**

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

**Trading Securities and Available-for-Sale Securities**

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

   a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)

   b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

**Reporting Changes in Fair Value**

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders’ equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders’ equity.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.
Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.4 If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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4 A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No.59, Accounting for Noncurrent Marketable Equity Securities.

29. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

Loan Origination Fees and Costs

5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield2 (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

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2 Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other
ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

a. If the enterprise’s experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.

b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan’s principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in
The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. (Refer to Appendix B.)

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6 The "interest" method is also described in paragraph 16 of APB Opinion No. 12, Omnibus Opinion--1967, in the first sentence of paragraph 15 of APB Opinion No. 21, Interest on Receivables and Payables, and in paragraphs 235-239 of FASB Concepts Statement No. 6, Elements of Financial Statements.

7 A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).
estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

a. For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.8

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8 For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

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30. FAS 125 provides the following guidance:

28. To be substantially the same,9 the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)

b. Identical form and type so as to provide the same risks and rights

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

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9 In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.
31. AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) provides the following guidance:

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.1

1 The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.2

2 For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.3

3 For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.4

4 For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.
Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

### RELEVANT LITERATURE

#### Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 73 - Nonmonetary Transactions
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Purposes and Procedures of the Securities Valuation Office of the NAIC

#### Generally Accepted Accounting Principles
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- AICPA SOP 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position
- AICPA SOP 90-11, Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets
- AICPA Practice Bulletin No. 4, Accounting for Foreign Debt/Equity Swaps
- FASB Emerging Issues Task Force No. 89-18, Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA
- FASB Emerging Issues Task Force No. 96-10, Impact of Certain Transactions on Held-to-Maturity Classifications Under FASB Statement No. 115

#### State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 27
Disclosure of Information about Financial Instruments with Concentration of Credit Risk

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE
1. In the normal course of business, insurance enterprises enter into transactions involving investment contractual relationships which include but are not limited to time deposits, short-term investments, bonds, preferred stocks, mortgage loans, deposit accounts and notes payable, collectively called financial instruments. Many of these transactions can result in concentrations of credit risks in that significant fluctuations in one area of a financial market could result in material adverse financial consequences to an insurance enterprise. With certain exceptions, current statutory guidance does not require financial statement disclosure of financial instruments with concentration of credit risk. GAAP has specific disclosure requirements for financial instruments which have concentration of credit risk. This issue paper establishes statutory accounting principles for disclosure of financial instruments with concentration of credit risk that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION
2. Except as noted in paragraph 14 of FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk (FAS 105), (included in the Relevant GAAP Guidance section of this Issue Paper), a reporting entity shall disclose all significant concentrations of credit risk arising from all financial instruments whether from an individual or group. Group concentrations of credit risk exist if a number of individuals or groups are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed in the notes to the financial statements about each significant concentration:
   a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration
   b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
   c. The entity’s policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity’s access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

DISCUSSION
3. The conclusion above adopts the provisions of FAS 105 as it relates to financial instruments with concentrations of credit risk (paragraphs 14 and 20). Disclosure of information about financial
instruments with off-balance-sheet risk relating to derivative financial instruments is covered in Issue Paper No. 85 - Derivative Instruments (Issue Paper No. 85) which contains all of the disclosure requirements for derivatives.

4. The Statement of Concepts states that "Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity’s short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management’s discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided." Disclosures of financial instruments with concentration of credit risk is consistent with that objective.

5. The following represent examples where disclosure of concentration of credit risk may be warranted. These examples are not intended to be all inclusive.

   a. Entities which invest in mortgage loans wherein a substantial portion of the loans are in farms and the debtors’ ability to honor the contract is dependent upon the agribusiness economic sector.

   b. Entities investing in mortgage loans wherein a substantial portion of the loans are located in one geographic region and the debtors’ ability to honor the contract is dependent upon the economic stability of that region.

Drafting Notes/Comments

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

6. There is no statutory guidance on disclosures about concentrations of credit risk. However, the NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require information about the geographic location of certain investments which provides some information about concentrations of credit risk (e.g. Schedule B on mortgage).

Generally Accepted Accounting Principles

7. FAS 105 discusses disclosure of concentration of credit risk as follows:

   6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

   a. Imposes on one entity a contractual obligation\(^1\) (1) to deliver cash or another financial instrument\(^2\) to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

\(^1\) Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as liabilities in financial statements -- may be "off-balance-sheet"—because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

\(^2\) The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), but it is not circular. It requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver
financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

3 Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements -- may be “off-balance-sheet”--because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is held by or due from a group of entities rather than a single entity.

7. The risk of accounting loss from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk), and (c) the risk of theft or physical loss. This statement addresses credit and market risk only.

4 Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

5 A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

8. Some financial instruments are recognized as assets, and the amount recognized reflects the risk of accounting loss to the entity. A receivable that is recognized and measured at the present value of future cash inflows, discounted at the historical interest rate (often termed amortized cost), is an example: the accounting loss that might arise from that account receivable cannot exceed the amount recognized as an asset in the statement of financial position.6

6 It is possible that an economic loss could exceed that amount if, for example, the current market value of an asset was higher than the amount recognized in the statement of financial position. This Statement, however, does not address that economic loss.

12. This Statement requires disclosure of information about financial instruments that have off-balance-sheet risk and about financial instruments with concentrations of credit risk except as specifically modified by paragraphs 14 and 15. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

14. The requirements of paragraphs 17, 18, and 20 do not apply to the following financial instruments, whether written or held:

a. Insurance contracts, other than financial guarantees and investment contracts, as discussed in FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, and No. 97, Accounting and Reporting by Insurance
Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

b. Unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, Disclosure of Long-Term Obligations

Unconditional purchase obligations not subject to the requirements of Statement 47 are included in the scope of this Statement. That is, unconditional purchase obligations that require the purchaser to make payment without regard to delivery of the goods or receipt of benefit of the services specified by the contract and are not within the scope of Statement 47 (because they were not negotiated as part of a financing arrangement, for example) are included in the scope of this Statement.

c. Employers’ and plans’ obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers’ Accounting for Pensions, No. 81, Disclosure of Postretirement Health Care and Life Insurance Benefits, No.43, Accounting for Compensated Absences, as well as APB Opinions No. 25, Accounting for Stock Issued to Employees, and No. 12, Omnibus Opinion--1967

d. Financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of Statement 87

Financial instruments of a pension plan, other than the obligations for pension benefits, when subject to the accounting and reporting requirements of Statement 35 are included in the scope of this Statement.

e. Substantively extinguished debt subject to the disclosure requirements of FASB Statement No. 76, Extinguishment of Debt, and any assets held in trust in connection with an in-substance defeasance of that debt.

16. Generally accepted accounting principles contain specific requirements to disclose information about the financial instruments noted in paragraphs 14 and 15, and this Statement does not change those requirements. For all other financial instruments, the requirements in this Statement are in addition to other disclosure requirements prescribed by generally accepted accounting principles.

Disclosure of Concentrations of Credit Risk of All Financial Instruments

20. Except as noted in paragraph 14, an entity shall disclose all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties. Group concentrations of credit risk exist if a number of counterparties are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. The following shall be disclosed about each significant concentration:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration.

b. The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity.
c. The entity’s policy of requiring collateral or other security to support financial
instruments subject to credit risk, information about the entity’s access to that
collateral or other security, and the nature and a brief description of the collateral
or other security supporting those financial instruments.

8. Paragraphs 9, 10, 11, 13, 15, 17, 18, and 19 of FAS 105 have been deleted from this section as
they deal with Off-Balance sheet risk which will be addressed in Issue Paper No. 85.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and
  Casualty Insurance Companies

Generally Accepted Accounting Principles
- FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-
  Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 28
Short-term Investments

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Short-term investments are investments which generally are in the form of bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans, whose maturity dates (or repurchase dates) at the time of acquisition were one year or less. Current statutory accounting guidance requires short-term investments to be carried in the same manner as similar long-term investments. Any premium or discount is amortized on a straight-line basis through the maturity date of the investment. This is different from GAAP which does not have the classification of short-term investments.

2. The purpose of this issue paper is to define short-term investments and to establish statutory accounting principles and related reporting that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding those investments classified as cash equivalents as defined in Issue Paper No. 2—Definition of Cash (Issue Paper No. 2)) shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans which meet the above criteria. Short-term investments shall not include certificates of deposit with contractual maturities of one year or less at the time of acquisition. In accordance with Issue Paper No. 2, these investments shall be classified as cash.

4. All short-term investments shall be accounted for in the same manner as similar long-term investments. Investments in money market funds shall be reported in accordance with the guidance in the Procedures for Valuing Common Stocks and Stock Warrants section of the Purposes and Procedures Manual of the Securities Valuation Office of the NAIC.

5. The following disclosures shall be made for short-term investments in the notes to the financial statements:
   
a. Fair values in accordance with Issue Paper No. 33 - Disclosures about Fair Value of Financial Instruments;

b. Concentrations of credit risk in accordance with Issue Paper No. 27 - Disclosure of Information about Financial Instruments with Concentration of Credit Risk;

c. Basis at which the short-term investments are stated.
DISCUSSION

6. The conclusion above rejects FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), for those securities which have maturities of one year or less from the date of acquisition. The conclusion above is consistent with existing statutory guidance.

7. The above conclusion requires separate classification of those investments held by a reporting entity which have maturity dates of one year or less at the time of their acquisition from those with maturity dates of over one year at acquisition. The Statement of Concepts states that “the cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders.”

8. GAAP classifies securities with original maturities of ninety days or less as cash equivalents and those over ninety days in one of the following categories in accordance with FAS 115: 1) trading; 2) available-for-sale; 3) held-to-maturity. Issue Paper No. 2 defines cash as “a medium of exchange that a bank will accept for deposit and allow an immediate credit to the depositor’s account.” Moreover, statutory accounting guidance does not recognize the GAAP classification of investments contained in FAS 115.

9. Negotiable certificates of deposit with a contractual maturity of one year or less at acquisition will no longer be classified as short-term investments. This change was made to address inconsistencies in the guidance between the Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies and Life and Accident and Health Insurance Companies (P&C and Life/A&H Accounting Practices and Procedures Manuals) and The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures). The P&C and Life/A&H Accounting Practices and Procedures Manuals require all nonnegotiable certificates of deposit to be classified as cash and negotiable certificates of deposit to be classified as short-term investments or bonds depending on the length to maturity at acquisition. The SVO Purposes and Procedures requires both negotiable and nonnegotiable certificates of deposit to be submitted to the SVO and valued under the general provisions for valuing bonds.

Drafting Notes/Comments
- Bonds and other long-term investments are addressed in separate issue papers.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Statutory accounting guidance is contained in the P&C and Life/A&H Accounting Practices and Procedures Manuals, Chapter 5, Cash and Short-term Investments. Chapter 5 states:

   Short-term Investments

   Short-term investments are generally in the form of bonds, commercial paper, money market instruments, repurchase agreements, or collateral and mortgage loans whose maturities (or repurchase dates under repurchase agreements) at time of acquisition were one year or less.

   The accounting for short-term investments is the same as for similar long-term investments except that the method of accrual and amortization is always straight line and the assets are always valued at book value or market value.

11. Guidance for investments in money market funds is contained in the SVO Purposes and Procedures. Section 5(A) - Procedures for Valuing Common Stocks and Stock Warrants, states:
Shares of mutual funds, except for certain money market funds as defined by 17 CFR 270.2a-7 under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and further defined in section 5(A)(a)(i) and 5(A)(a)(ii), regardless of the types or mix of securities owned (bonds, stock, money market instruments, or other type of investments) by the fund, are considered to be common shares which should be reported on Schedule D-Part 2-Section 2.

(i) A money market fund shall not require a reserve if the fund meets all of the following conditions:
   (1) The fund shall maintain a money market fund rating in the highest category from an SVO recognized rating agency; and
   (2) The fund shall maintain a constant net asset value per share at all times; and
   (3) The Fund shall allow a maximum of seven day redemption of proceeds; and
   (4) (a) The fund shall invest 100% of its total assets in U.S. treasury bills, notes, and bonds and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(F) for a list of qualifying Funds), or
       (b) The fund shall invest 100% of its total assets in certain securities listed in Section 6(B)(g)(i) and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(G) for a list of qualifying Funds).

(ii) A money market fund shall establish a reserve using the bond class one reserve factor if the fund meets all of the following conditions:
   (1) The fund shall invest at least 95% of its total assets in exempt securities listed in Section 6A(a), short-term debt instruments with a maturity of 397 days or less, class one bonds, and collateralized repurchase agreements comprised of those securities at all times (see Section 5(H) for a list of qualifying Funds): and
   (2) The fund shall maintain a money market fund rating in the highest category by an SVO approved rating agency: and
   (3) The fund shall maintain a constant net asset value per share at all times: and
   (4) The fund shall allow a maximum of seven day redemption of proceeds:

(iii) A money market fund which qualifies for reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii) shall be reported on Schedule DA-Part 1.

(iv) In order to qualify for a reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii), a money market fund shall submit documentation on forms provided by the SVO staff. The forms shall include sufficient information to demonstrate compliance with the above requirements.

(v) In order to maintain the qualifications for exemption or inclusion in the bond class one reserve category, the fund shall report annually, current fund information to the SVO staff by November 15. In addition, the fund shall report to the SVO any change in investment policy which requires notice to shareholders.
12. Section 2(C)(7) of the SVO Purposes and Procedures indicates the following requirements for certificates of deposit: “Certificates of Deposit (negotiable and non-negotiable) will be considered under the general provisions of Section 2(B).”

**Generally Accepted Accounting Principles**

13. GAAP does not make the distinction between short-term and long-term investments. All investments in equity securities that have readily determinable fair values and all investments in debt securities follow FAS 115, which states:

a. Debt and equity securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.

b. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.

c. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders’ equity.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 5, *Cash and Short-term Investments*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 5, *Cash and Short-term Investments*
- Issue Paper No. 2 - Definition of Cash
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 2 and Section 5

**Generally Accepted Accounting Principles**
- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 29

Prepaid Expenses (excluding Deferred Policy Acquisition Costs and other underwriting expenses, income taxes and Guaranty Fund Assessments)

STATUS
Finalized March 16, 1998

Type of Issue:
Common area

SUMMARY OF ISSUE

1. A prepaid expense is an amount which has been paid in advance of receiving future economic benefits anticipated by the payment. Current statutory accounting guidance requires prepaid expenses to be recorded as nonadmitted assets. This conflicts with the GAAP treatment which states that prepaid expenses are to be recorded as assets and expensed over the period that the benefits are received from the payment.

2. The purpose of this paper is to establish statutory accounting principles for the accounting for prepaid expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Prepaid expenses generally meet the definition of an asset in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Such expenditures also meet the criteria defining nonadmitted assets as specified in Issue Paper No. 4 (i.e. the assets are not readily available to satisfy policyholder obligations). Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus). They shall be amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s capitalization policy, immaterial prepaid expenses may be expensed when purchased.

DISCUSSION

4. The conclusion above is consistent with the definition of nonadmitted assets as noted in Issue Paper No. 4, which defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Issue Paper No. 4 further states that an asset that is not readily available to satisfy policyholder obligations shall be reported as a nonadmitted asset. Prepaid expenses meet the definition of a assets as they represent future economic benefits obtained as a result of past transactions. Additionally, prepaid expenses meet the definition of nonadmitted assets because they are not readily available to satisfy policyholder obligations.

Drafting Notes/Comments
- Guaranty fund assessments are addressed in Issue Paper No. 35 - Accounting for Guaranty Fund and Other Assessments.
- Accounting for income taxes is addressed in Issue Paper No. 83 - Accounting for Income Taxes.
- Deferred policy acquisition costs and other underwriting expenses are addressed in Issue Paper No. 71 - Policy Acquisition Costs and Commissions.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

6. Many states also include prepaid expenses as nonadmitted assets. An example is the Regulations of the Alabama Insurance Department, Regulation No. 18, *Admissibility of Assets*, which states “Admitted assets, for example, will not include such items as furniture and fixtures, automobiles, supplies, prepaid expenses...”.

7. Some states nonadmit most prepaid expenses but allow particular prepaid expenses to be recorded as admitted assets. An example is the Virginia Insurance Laws, Title 38.2 - Insurance, Chapter 13, *Reports, Reserves and Examination, Insurance Holding Companies*, Article 2. Valuation and Admissibility of Assets which nonadmits “prepaid and deferred expenses except prepaid property taxes.”

Generally Accepted Accounting Principles
8. Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 3, Working Capital, states:

   4. For accounting purposes, the term current assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. Thus the term comprehends in general such resources as...(g) prepaid expenses such as insurance, interest, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 9, *Nonadmitted Assets*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 9, *Nonadmitted Assets*

Generally Accepted Accounting Principles
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 3, *Working Capital*
- AICPA Practice Bulletin No. 13, *Direct-Response Advertising and Probable Future Benefits*
- AICPA Statement of Position 93-7, *Reporting on Advertising Costs*
- FASB Emerging Issues Task Force No. 88-23, *Lump-Sum Payments under Union Contracts*

State Regulations
- Virginia Insurance Laws, Title 38.2 - Insurance, Chapter 13, *Reports, Reserves and Examination, Insurance Holding Companies*, Article 2. Valuation and Admissibility of Assets
- Regulations of the Alabama Insurance Department, Regulation No. 18, *Admissibility of Assets*
Statutory Issue Paper No. 30

Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

Status
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to the valuation of and accounting for common stock is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also established the NAIC’s Securities Valuation Office (SVO) as the primary authority for the valuation of common stocks. The purpose of this issue paper is to establish statutory accounting principles for common stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Accounting for investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in a separate issue paper.

SUMMARY CONCLUSION

3. For purposes of statutory accounting, common stocks (excluding investments in affiliates) are securities which represent a residual ownership in a corporation and shall include:

   a. Publicly traded common stocks.

   b. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges.

   c. Publicly traded common stock warrants.

   d. Shares of mutual funds, except for certain money market funds and Class 1 Bond Funds as designated in the Purposes and Procedures of the Securities Valuation Office of the NAIC, regardless of the types or mix securities owned by the fund (e.g., bonds, stock, money market instruments, or other type of investments).

   e. Common stocks that are not publicly traded.

   f. Common stocks that are restricted as to transfer of ownership. Restricted stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.

4. Common stocks meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this paper.
5. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

6. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date). For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for realized capital gains and losses on sales of common stock shall be in accordance with Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve (Issue Paper No. 7). For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

7. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. At each reporting date, investments in common stocks shall be valued and reported in accordance with the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners. In those instances where fair market value is not available from the SVO, it is the responsibility of management to determine market value based on analytical or pricing mechanisms. For reporting entities required to maintain an AVR, the accounting for unrealized capital gains and losses shall be in accordance with Issue Paper No. 7. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

8. For any decline in the fair value of a common stock which is determined to be other than temporary, the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with Issue Paper No. 7. Subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value (association value). This is consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

9. An investor can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

**Loaned Stock**

10. When stocks are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the owner of the stocks. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.
Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges
11. Stock splits, stock dividends, payment in kind dividends and stock exchanges shall be accounted for in accordance with Issue Paper No. 73 - Nonmonetary Transactions.

Disclosures
12. The following disclosures shall be made for common stocks in the notes to the financial statements.

   a. Basis at which the common stocks are stated.

   b. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral, a description of any loaned common stocks, including the amount, description of the collateral and whether or not the collateral is restricted.

   c. A description, as well as the amount, of common stock that is restricted and the nature of the restriction.

DISCUSSION

13. The statutory accounting principles described in paragraphs 3 through 7 and in paragraph 10 above are consistent with current statutory accounting guidance for common stocks. This issue paper rejects the accounting principles set forth in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). The statutory accounting principles described above add additional conservatism to existing statutory guidance by adopting the concept of other than temporary declines and requiring those be charged to realized losses (paragraph 8) and requiring that certain common stock transactions not be recorded until settlement date (paragraph 9).

14. This issue paper adopts paragraphs 9 through 12, 15, 17, 23 through 31 and 61 through 65 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Exinguishments of Liabilities (FAS 125) as they relate to common stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the “loaned” securities.

15. Paragraph 14 of FAS 125 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities.

16. The statutory accounting principles outlined in the conclusion above are consistent with the concept of recognition in the Statement of Concepts. Pertinent excerpts follow:

   Recognition

   The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability becomes questionable.
Drafting Notes/Comments
- Accounting for common stock holdings of subsidiary, controlled and affiliated entities is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due and Accrued.
- Accounting for the Asset Valuation Reserve (AVR) equity component required for common stock holdings will be addressed in Issue Paper No. 7 – Asset Valuation Reserve and Interest Maintenance Reserve.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to common stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)

Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.

Valuation

Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAICs Valuation of Securities Task Force at the end of each year. This value is the subcommittee's determination of "market" for each listed stock.

The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.

Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.
Dividends

Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The Valuations of Securities manual has a complete listing of all stocks that are traded "ex-dividend" at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

Loaned Stock

Where the law or regulation of the insurer's state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealer or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer's custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

As stated in the NAIC Valuations of Securities manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily "mark to market" or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.

If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC Valuations of Securities manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.
The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

18. The SVO Purposes and Procedures - Section 5 - Procedures for Valuing Common Stocks and Stock Warrants contains the following guidance:

(A) Common Stocks of Companies Not Classified as Being Subsidiaries, Controlled or Affiliated, Under Section 5(B).

(a) Association values for publicly traded common stocks and warrants, including, where permitted by law or regulation of an insurer's state of domicile, shares against which exchange traded call options are outstanding, and where the requirements of Section 5(C)(1) are met, shall be equal to market value at date of statement, excepting that, where permitted by law or regulation of an insurer's state of domicile, shares loaned to others shall be valued at the market value at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value or the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

Shares of mutual funds, except for certain money market funds as defined by 17 CFR 270.2a-7 under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and further defined in section 5(A)(a)(i) and 5(A)(ii), regardless of the types or mix of securities owned (bonds, stock, money market instruments, or other type of investments) by the fund, are considered to be common shares which should be reported on Schedule D-Part 2-Section 2.

(i) A money market fund shall not require a reserve if the fund meets all of the following conditions:

1. The fund shall maintain a money market fund rating in the highest category from an SVO recognized rating agency; and

2. The fund shall maintain a constant net asset value per share at all times; and

3. The Fund shall allow a maximum of seven day redemption of proceeds; and
(4) (a) The fund shall invest 100% of its total assets in U.S. treasury bills, notes, and bonds and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(F) for a list of qualifying Funds), or

(b) The fund shall invest 100% of its total assets in certain securities listed in Section 6(B)(g)(i) and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(G) for a list of qualifying Funds).

(ii) A money market fund shall establish a reserve using the bond class one reserve factor if the fund meets all of the following conditions:

(1) The fund shall invest at least 95% of its total assets in exempt securities listed in Section 6A(a), short-term debt instruments with a maturity of 397 days or less, class one bonds, and collateralized repurchase agreements comprised of those securities at all times (see Section 5(H) for a list of qualifying Funds): and

(2) The fund shall maintain a money market fund rating in the highest category by an SVO approved rating agency: and

(3) The fund shall maintain a constant net asset value per share at all times: and

(4) The fund shall allow a maximum of seven day redemption of proceeds:

(iii) A money market fund which qualifies for reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii) shall be reported on Schedule DA-Part 1.

(iv) In order to qualify for a reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii), a money market fund shall submit documentation on forms provided by the SVO staff. The forms shall include sufficient information to demonstrate compliance with the above requirements.

(v) In order to maintain the qualifications for exemption or inclusion in the bond class one reserve category, the fund shall report annually, current fund information to the SVO staff by November 15. In addition, the fund shall report to the SVO any change in investment policy which requires notice to shareholders.

(b) Association Values for common stocks which are not publicly traded, other than those issued by insurance companies (for which see Section (c) hereunder), shall be determined by the SVO Staff.

(c) Association Values for common stocks which are not publicly traded which are issued by insurance companies will be equal to book value, which shall be calculated as follows: by dividing the amount of its capital and surplus as shown in its last annual statement or subsequent report of examination (excluding from surplus, reserves required by statute and any portion of surplus properly allocable to policyholders, rather than stockholders) less the value (par or redemption value, whichever is the greater) of all of its preferred stock, if any,
outstanding, by the number of shares of its common stock issued and outstanding.

(d) The foregoing provisions shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of stocks of insurance companies.

(B) Common Stocks of Subsidiary, Controlled or Affiliated Companies (section not included as not relevant to this issue paper)

(C) Stock Warrants.

(1) Stock Warrants.

All warrants which are exercisable on the date of the Statement shall be valued at Association Value as defined below whether or not physically attached to any other security (See (D), hereunder, for the valuation of warrants exercisable into securities which are restricted as to transferability.)

(a) For publicly traded warrants (other than exchange traded) the Association Value shall be equal to market value.

(b) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have no public market shall be the difference resulting from the subtraction from the analytically determined Association Value of the stock of the exercise price for the warrant.

(c) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have a counterpart public market but which are themselves restricted shall be the difference resulting from the subtraction from the value of the common shares as determined under the procedures of Section 5(D) below of the exercise price for the warrant.

(d) Warrants having no public market and for which the first exercise date is subsequent to the date of the statement shall have no value for statement purposes.

(D) Common Stocks Having a Public Market Which Are Issued Under an Investment Letter or Are Otherwise Restricted as to Transferability.

Restricted common stocks (which for purposes of this section, are defined as restricted shares of an unaffiliated issuer held for a period of less than three years prior to the date of valuation) shall be valued by insurers in their Annual Statements on a basis which they are prepared to justify to the SVO staff. (Restrictions shall be considered to have expired for common stocks held at least three years prior to the date of valuation, and the regular valuation basis shall apply.) Such values shall be reviewed by the SVO staff as to the reasonableness of the valuation basis used. The results of the SVO staff's review will be made available to insurance departments and upon request to insurers holding said restricted common stocks.

Warrants exercisable into such restricted common stocks will be valued on the same special basis.

All restricted common stocks and warrants exercisable into the same should be appropriately noted in the Annual Statement, as required, in Schedule D- Part 2-Section 2.
Investments in Common Stock, (excluding investments in common stock of subsidiary, controlled, or affiliated entities)

Market values, where used in the determination of Association Values carried in the SVO manual, are not intended for use in valuing restricted common stocks, warrants as described in this section. Values for such restricted common stocks, warrants will not be carried in the SVO publication.

(E) Exceptions.

Where required by special conditions the foregoing standards may be varied by the Task Force.

(F) Money Market Funds Filed With The SVO Which Qualify Under Section 5(A)(a)(i)(4)(a)

(listing not included for purposes of this issue paper)

19. Several states have statutes that address valuation of common stocks not listed in the Valuations of Securities manual. In addition, one state clarifies the definition of common stock. See excerpts below:

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311:

  As used in this section the term "common stock" includes transferable certificates of participation in business trusts.

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets

6. Common Stocks.

  a. Common stocks are to be valued at market value. Market value as used for valuation of common stocks means in accordance with the values listed in "Valuation of Securities." For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed in and not actively traded on a registered national securities exchange shall have a market value in an amount that the insurer can justify to the commissioner.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

(A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

  (a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (i) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.
(b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.

(c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.

- Florida Statutes - Insurance Laws, TITLE XXXVII--INSURANCE, Chapter 625--Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

(1) Securities, other than those referred to in §§ 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.

- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120.--Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5--Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

(1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:

(a) Other than the nonadmissible exceptions listed in paragraph (2) of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners' Valuation of Securities Task Force publication, Valuations of Securities, for the applicable year.

(b) Securities not listed in the National Association of Insurance Commissioners' Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

Generally Accepted Accounting Principles

20. FAS 115, paragraph 12, provides the following guidance with respect to common stocks:

Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. (Note: remainder of paragraph not reproduced as not applicable to equity securities)

b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

21. Paragraph 13 of FAS 115 discusses reporting changes in fair value and states the following:

Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109,
Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

22. Paragraph 14 of FAS 115 discusses income recognition and states the following:

Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

23. Paragraph 16 of FAS 115 discusses impairment of securities and states the following:

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in the fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

4 A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.

24. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entities and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).
10. Upon completion of any transfer of financial assets, the transferor shall:
   a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33).
   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
   a. Derecognize all assets sold
   b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
   c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
   d. Recognize in earnings any gain or loss on the sale. The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

3 Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:
   a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the
Investments in Common Stock, (excluding investments in common stock of subsidiary, controlled, or affiliated entities)  IP No. 30

collateral on short notice, for example, by substituting other collateral or terminating the contract, then
(i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
(ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor’s right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:
   (1) The amounts of servicing assets or liabilities recognized and amortized during the period
   (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
   (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
   (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.
Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity must meet both of the following conditions:

a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
   (1) Holding title to transferred financial assets
   (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
   (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
   (4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." In
that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

7 The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

8 Scott’s Abridgment of the Law on Trusts, §156 (Little, Brown and Company, 1960), 296.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
   b. Identical form and type so as to provide the same risks and rights
   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
   d. Identical contractual interest rates
   e. Similar assets as collateral
   f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

9 In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor’s effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.
Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"\(^{11}\) and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

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\(^{11}\) If the "collateral" is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.
64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

65. Accounting for a securities lending transaction treated as a secured borrowing:

**Facts**
- Transferor’s carrying amount and fair value of security loaned: $1,000
- Cash “Collateral”: 1,020
- Transferor’s return from investing cash collateral at a 5 percent annual rate: 5
- Transferor’s rebate to the borrower at a 4 percent annual rate: 4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

**Journal Entries for the Transferor**

**At inception:**
- Cash 1,020
- Payable under securities loan agreements 1,020
- To record receipt of cash collateral

- Securities loaned to broker 1,000
- Securities 1,000
- To reclassify loaned securities that cannot be redeemed on short notice

- Money market instrument 1,020
- Cash 1,020
- To record investment of cash collateral

**At conclusion:**
- Cash 1,025
  - Interest 5
  - Money market instrument 1,020
- To record results of investment

- Securities 1,000
- Securities loaned to broker 1,000
- To record return of security

- Payable under securities loan agreements 1,020
  - Interest ("rebate") 4
    - Cash 1,024
- To record repayment of cash collateral plus interest

**Journal Entries for the Transferee**

**At inception:**
- Receivable under securities loan agreements 1,020
- Cash 1,020
- To record transfer of cash collateral
At conclusion:

Obligation to return borrowed securities 1,000
Securities 1,000
To record the return of securities

Cash 1,024
Receivable under securities loan agreements 1,020
Interest revenue ("rebate") 4
To record the receipt of cash collateral and rebate interest

Repurchase Agreements and “Wash Sales”
69. Furthermore, “wash sales” that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life an Accident and Health Insurance Companies, Chapter 2, Stocks
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 2, Stocks
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 5 - Procedures for Valuing Common Stocks and Stock Warrants
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Issue Paper No. 73 - Nonmonetary Transactions

Generally Accepted Accounting Principles
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Exinguishments of Liabilities

State Regulations
- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments
- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation
- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values
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Statutory Issue Paper No. 31

Leasehold Improvements Paid by the Reporting Entity as Lessee

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for leasehold improvements is limited and does not give specific guidance as to admissibility. Leasehold improvements are referred to in the real estate section of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. GAAP guidance allows leasehold improvements to be recorded as assets.

2. This issue paper establishes statutory accounting principles for leasehold improvements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For statutory accounting purposes, leasehold improvements shall be defined as lessee expenditures that are permanently attached to an asset a reporting entity is leasing under an operating lease.

4. Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Such expenditures also meet the criteria defining nonadmitted assets in that same paper (i.e., the asset is not readily marketable and available to satisfy policyholder obligations). Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus and shall be amortized against net income over the shorter of their estimated useful life or the remaining life of the original lease excluding renewal or option periods as defined in Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements. Leasehold improvements that do not meet the definition of an asset shall be charged to expense when acquired.

DISCUSSION

5. Issue Paper No. 4 defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Issue Paper No. 4 also states that an asset not readily marketable and available to satisfy policyholder obligations “shall be recorded as a nonadmitted asset and charged against surplus.” This is consistent with the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” Leasehold improvements meet the definition of an asset in that they provide future economic benefit to the reporting entity. However, because such assets are not readily available to satisfy policyholder obligations (i.e., they will revert to the lessor at the end of the lease term) they are considered nonadmitted assets. This is also consistent with the concept of conservatism included in the Statement of Concepts.
Drafting Notes/Comments
- Accounting for leases is addressed in Issue Paper No. 22 - Leases.
- Lessors often provide or pay for improvements to leased property; Issue Paper No. 22 requires lessees to consider the value of such concessions and normalize rent revenue and rent expense on operating leases.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
6. Current statutory guidance is in the Accounting Practices and Procedures Manual for Life and Accident and Health and for Property and Casualty Insurance Companies, Chapter 4, Real Estate. Chapter 4 states:

Because real estate leasehold improvements revert to the lessor at the end of the lease and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

Generally Accepted Accounting Principles
7. GAAP guidance is very limited other than in FASB Statement of Financial Accounting Concept No. 6, Elements of Financial Statements (CON 6), which states:

Most assets presently included in financial statements qualify as assets under the definition in paragraph 25 because they have future economic benefits... Inventories of raw materials, supplies, partially completed products, finished goods, and merchandise likewise obviously fit the definition as do productive resources, such as property, plant, equipment, tools, furnishings, leasehold improvements, natural resource deposits, and patents.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 4, Real Estate
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 22 - Leases

Generally Accepted Accounting Principles
- FASB Statement of Financial Accounting Concept No. 6, Elements of Financial Statements

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 32

Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to the valuation of and accounting for preferred stock is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also established the NAIC’s Securities Valuation Office (SVO) as the primary authority for the valuation of preferred stocks. The purpose of this issue paper is to establish statutory accounting principles for preferred stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Accounting for investments in preferred stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.

SUMMARY CONCLUSION

3. For purposes of statutory accounting, preferred stocks (excluding investments in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

   a. Redeemable preferred stocks (including mandatory sinking fund preferred stocks and preferred stocks redeemable at the option of the holder).

   b. Perpetual preferred stocks including nonredeemable preferred stocks and preferred stock redeemable at the option of the issuer.

Redeemable preferred stock shall be defined as preferred stock that by its terms must be redeemed by the issuing enterprise or is redeemable at the option of the investor. They include mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock. Mandatory sinking fund preferred stocks shall be defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which do not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise. Payment-in-kind (PIK) preferred stocks shall be defined as redeemable preferred stocks on which dividends can be paid in additional securities rather than cash at the option of the issuer. Perpetual preferred stock shall be defined as preferred stock with no redemption or sinking fund features and preferred stock redeemable at the option of the issuer.
4. Preferred stock meets the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and is an admitted asset to the extent it conforms to the requirements of this paper.

5. At acquisition, preferred stocks shall be reported at their cost, including brokerage and other related fees. Cost shall not exceed market value. Preferred stock acquisitions and dispositions shall be recorded on the trade date, not the settlement date except for private placement preferred stocks which shall be recorded on the funding date.

6. Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value. Redeemable preferred stock purchased at a discount shall be amortized to increase the carrying value to par value over the period to maturity or the latest redemption date. Amortization shall be calculated using the interest method and shall be reported as increases or decreases in dividends collected during the year.

7. Dividends on preferred stock (whether cumulative or noncumulative) other than mandatorily redeemable preferred stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on preferred stocks declared to be ex-dividend on or prior to the statement date). Dividends on mandatorily redeemable preferred stock shall be accrued, even if not declared, using the interest method to the redemption price over the period ending on the redemption date.

8. For purposes of statutory accounting, preferred stocks shall be valued based on a) the underlying characteristics of the security, b) the quality rating of the security as defined in the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures) and reported in the Valuations of Securities manual published by the NAIC’s Valuation of Securities Task Force at the end of each year and c) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity.

Reporting Entities That Do Not Maintain An AVR
9. Highest-quality or high-quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality or high-quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at market value as reported in Valuations of Securities manual. Other perpetual preferred stock shall be valued at lower of cost or market value.

Reporting Entities That Do Maintain An AVR
10. Highest-quality, high-quality or medium quality redeemable preferred stocks (which have characteristics of a debt security) shall be valued at cost or amortized cost. Other redeemable preferred stocks shall be valued at the lower of cost, amortized cost or market value. Highest-quality, high-quality or medium quality perpetual preferred stocks (which have characteristics of an equity security) shall be valued at cost. Other perpetual preferred stock shall be valued at the lower of cost or market value.
Additional Valuation Guidance Applicable To All Reporting Entities

11. The SVO Purposes and Procedures classifies preferred stocks into six redeemable preferred stock quality categories and into six perpetual preferred stock quality categories. Preferred stocks shall be classified in accordance with the Valuations of Securities manual published by the NAIC’s Valuation of Securities Task Force each reporting date. Unrealized gains and losses on perpetual preferred stocks shall be included as a direct credit or charge to surplus.

12. Restricted preferred stock shall be defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause the requirement to be met within one year. Any portion of the security that can be reasonable expected to qualify for sale within one year is not considered restricted.

13. PIK preferred stocks are considered redeemable preferred stock and shall be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends. PIK stocks received as dividends should be recorded at market value. Any cash dividends paid during the stock dividend period on PIK stocks shall be accounted for as a reduction in the investment.

14. For any decline in the fair value of a preferred stock which is determined to be other than temporary, the cost basis of the preferred stock shall be written down to fair market value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve. For perpetual preferred stock, subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Subsequent fluctuations in market value shall be recorded as unrealized gains and losses to the extent that they do not bring the investment above its new cost basis. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. For perpetual preferred stock, a decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security at an amount below its carrying value. This is consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. For redeemable preferred stock, when a decline in fair value is determined to be other than temporary, the investment should be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For redeemable preferred stock, an impairment shall be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security in effect at the date of acquisition. A decline in fair value which is other than temporary includes situations where an investor has made a decision to sell a security prior to its maturity at an amount below its carrying value (i.e., amortized cost).

15. A reporting entity can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Preferred stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).
Loaned Preferred Stock
16. When preferred stocks are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the stocks. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

Wash Sales
17. When preferred stock is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 20. Unless there is a concurrent contract to repurchase or redeem the transferred preferred stock from the transferee, the transferor does not maintain effective control over the preferred stock.

18. For the securities to be substantially the same, the criteria set forth in paragraph 28 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) must be met.

Exchanges and Conversions
19. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. If the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered then it shall become the cost basis for the new securities. This treatment is consistent with Issue Paper No. 73 - Nonmonetary Transactions.

Disclosures
20. The following disclosures shall be made for all preferred stocks in the notes to the financial statements:

   a. Fair values in accordance with Issue Paper No. 33 - Disclosures about Fair Value of Financial Instruments;

   b. Concentrations of credit risk in accordance with Issue Paper No. 27 - Disclosure of Information about Financial Instruments with Concentrations of Credit Risk;

   c. Basis at which the preferred stocks are stated;

   d. Description of anyloaned preferred stock, including the amount, description of the collateral and whether or not the collateral is restricted;

   e. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.

   f. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 17, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

      1. A description of the reporting entity’s objectives regarding these transactions;

      2. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
3. The number of transactions involved during the reporting period;
4. The book value of securities sold;
5. The cost of securities repurchased;
6. The realized gains/losses associated with the securities involved.

DISCUSSION

21. The statutory accounting principles described above do not recognize the GAAP accounting principles for valuation set forth in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115); therefore, this issue paper rejects FAS 115.

22. The statutory accounting principles described above are consistent with current statutory accounting guidance for preferred stocks except as follows:

a. Specific guidelines for PIK preferred stocks are not included in current statutory guidance.

b. Specific guidelines for stock subscriptions are not included in current statutory guidance.

c. Specific guidelines for collateral deposited related to restricted stock that has been loaned are not included in current statutory guidance.

d. Specific guidelines for wash sales, other than transactions between affiliates, are not included in current statutory guidance.

23. This issue paper adopts paragraphs 9 through 12, 15, 17, 23 through 31 and 61 through 65 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Exinguishments of Liabilities (FAS 125) as they relate to preferred stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the “loaned” securities.

24. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under FAS 115. FAS 115 was rejected in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities (Issue Paper No. 26). This issue paper rejects FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary’s Mandatorily Redeemable Preferred Stock.

25. The statutory accounting principle outlined in the conclusion above accounts for preferred stocks based on the underlying characteristics of the securities and takes into consideration whether an Asset Valuation Reserve is maintained. This is consistent with the statutory accounting principles established in Issue Paper No. 26 and Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities). Under the statutory principles outlined in the conclusion above, preferred stocks with underlying characteristics of a debt security are valued similar to bonds and preferred stocks with underlying characteristics of an equity instrument are valued similar to common stocks (except for reporting entities that maintain an AVR, where they are valued at cost). This is consistent with the Statement of Concepts which states that “The regulator's need for meaningful, comparable financial information to determine an insurer’s financial condition requires consistency in the development and application of statutory accounting principles.”
Drafting Notes/Comments
- Accounting for preferred stock holdings of subsidiary, controlled and affiliated companies is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due and Accrued.
- Accounting for the Asset Valuation Reserve (AVR) default component required for preferred stock holdings is addressed in Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
26. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to preferred stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)

Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.

Preferred stock is a corporate financing method embodying features of common stock and debt. Preferred stockholders have a prior claim to common stockholders on income and assets, but rank below creditors. Ownership of preferred stock usually does not include voting privileges. Numerous options may be designed into the issue including call features, cumulative dividend entitlements, and earnings participation. Generally the dividend rate on preferred stock is determined at issue and does not reflect variations in earnings of the issuer.

Valuation
Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAIC’s Valuation of Securities Task Force at the end of each year. This value is the subcommittee’s determination of “market” for each listed stock.

Preferred stocks in good standing subject to a 100% mandatory sinking fund shall be carried at cost, unless the company owned the preferred stock on Dec, 31, 1964, in which case the company may have the option of reporting them either at the association value on that date or at company cost. Preferred stock that is not in good standing is to be reported at the lower of cost or association value.

The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.
Investments in Preferred Stock, (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.

Dividends
Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in “Investment Income Due and Accrued” in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The Valuation of Securities manual has a complete listing of all stocks that are traded “ex-dividend” at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

Loaned Stock
Where the law or regulation of the insurer’s state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealers or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer’s custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

As stated in the NAIC Valuations of Securities manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily “mark to market” or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.
If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC Valuations of Securities manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.

The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

27. The SVO Purposes and Procedures - Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks contains the following guidance:

(A) Purpose. The purpose of assigning an NAIC Designations P1-6 and PSF 1-6 is to determine the appropriate values to be entered in Schedule D and the AVR.

(B) General Procedures. For the purpose of analysis, preferred stocks are divided into two categories, perpetual and mandatory sinking fund preferred stocks. Perpetual preferreds are those which do not have any sinking fund provisions. Mandatory sinking fund preferred stock shall include those issues subject to a 100% mandatory sinking fund, annual installments of which will: (1) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (2) be not less than 2½% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (3) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. "Mandatory sinking fund preferred stock" that is subject to a 100% mandatory sinking fund, but that does not at date of issue, or December 31, 1978 if outstanding at that time, meet one or more of the other requirements of this Section, may qualify at such time as the deficiency is cured through the passage of time, or otherwise.

The analysis to determine an NAIC designation will be made in one of two ways. The first will be the direct use of ratings performed by other recognized rating agencies or organizations. The second will be the use of various security analysis techniques, both quantitative and subjective in nature.

(1) Issuers Which Have Securities Rated by Other Recognized Rating Agencies or Organizations.

Ratings of other recognized organizations will be translated directly into an NAIC Designation. The SVO staff will have discretionary authority to downgrade ratings of other organizations but not to upgrade. If there are multiple differing ratings the SVO may use the highest rating but may also go lower where indicated. Where one issue of an issuer has a rating, this rating will be used as a benchmark in determining the ratings of other non rated issues of the same issuer.

A list of the approved agencies and the translation of their rating into NAIC Designations is presented in Appendix B. To become an NAIC approved rating organization the candidate must apply to the NAIC’s Securities Valuation Office and file written documentation similar to that detailed in Section 2(B)(1) and an explanation of how their rating scale translates into the NAIC rating system.

(2) Issuers of Securities Which are Not Rated by Any Other Recognized Rating Organization.

The implied senior unsecured debt rating of any issuer will be used to determine how an issuer’s preferred stock will be rated. Preferreds will in general be given a rating grade equal to that of the real or implied most junior level of debt. For example, if senior unsecured debt is rated or has an implied rating of 3 then the subordinated debt of this issuer would be rated 4 and the preferred stock would also be rated a 4. Whether a preferred will be rated high quality or not will depend upon how much debt precedes it in the capital structure and how well both interest and preferred dividends are covered by earnings. All preferred dividends and sinking
Investments in Preferred Stock, (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

fund requirements must have been paid for the last three years for any preferred to be rated P-5, PSF-5 or higher.

(C) Special Factors.

(1) Market Values for Privately Placed Preferred Stock. In determining a price for a directly placed preferred, the SVO staff will first look for a publicly traded comparable preferred stock, (i.e. one with similar basic characteristics) of the same issuer and use the yield from that issue to price the private issue. If no comparable issues are available, the staff will use the yields from Moody’s Investors Services indices of preferred yields as of the close of the week preceding December 31.

(2) Preferred stocks of 100% owned insurance subsidiaries will be valued in the same manner as common stock of subsidiaries.

(3) Loaned Securities.

Where permitted by law or regulation of an insurer’s state of domicile, preferred stocks loaned to others shall be valued in accordance with Section 3(B) at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value or the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

(4) Other Limited Life Preferred Shares.

Some examples of these are: Dutch Auction Rate Preferred Shares (DARTS), Fixed Rate Adjustable Preferred Stock (FRAPS), Stated Term Auction Preferred Shares (STRAPS), Fixed Rate Exchangeable Preferred Stock (FREPS), Marketed Auction Preferred Shares (MAPS), Stated Rate Auction Preferred Shares (STAR), Share Adjusted Broker Remarketed Shares (SABRES). These shares will qualify to be valued at cost for companies maintaining an Asset Valuation Reserve and cost or amortized cost for all others as long as an “PSF 1 or 2,” “High Quality” designation, is maintained in both cases.
(D) **Instructions for Completing Schedule D of the NAIC Year End Annual Statement.**

The following tables indicate the appropriate entries to be entered in Schedule D Part 2-Section 1 of the NAIC Annual Statement for all preferred stocks.

1. **For Insurers Maintaining an Asset Valuation Reserve (AVR) (See Section 5)**

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<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>STATEMENT VALUE COLUMN</th>
<th>MARKET VALUE COLUMNS</th>
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<tbody>
<tr>
<td>PSF-1 Thru PSF-3</td>
<td>Cost or Amortized Cost</td>
<td>SVO</td>
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<td>Market Rate</td>
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<td>PSF-4 Thru PSF-6</td>
<td>Lower of Cost, Amortized Cost, or Market Value</td>
<td>SVO</td>
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<td>Market Rate</td>
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<tr>
<td>P-1 Thru P-3</td>
<td>Cost</td>
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<td>Market Rate</td>
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<td>P-4 Thru P-6</td>
<td>Lower of Cost or Market Value</td>
<td>SVO</td>
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<tr>
<td></td>
<td></td>
<td>Market Rate</td>
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</tbody>
</table>

Note: The quality ratings are defined in the SVO Purpose and Procedures as follows:

- **P-1**: Highest quality perpetual preferred stock
- **P-2**: High quality perpetual preferred stock
- **P-3**: Medium quality perpetual preferred stock
- **P-4**: Low quality perpetual preferred stock
- **P-5**: Lower quality perpetual preferred stock
- **P-6**: Lowest quality perpetual preferred stock

- **PSF1**: Highest quality sinking fund or limited life preferred stock
- **PSF2**: High quality sinking fund or limited life preferred stock
- **PSF3**: Medium quality sinking fund or limited life preferred stock
- **PSF4**: Low quality sinking fund or limited life preferred stock
- **PSF5**: Lower quality sinking fund or limited life preferred stock
- **PSF6**: Lowest quality sinking fund or limited life preferred stock
28. Several states have statutes that address valuation of preferred stocks. See excerpts below:

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets

5. Preferred and Guaranteed Stocks.

a. Preferred or guaranteed stocks in good standing are to be valued at cost by companies which are maintaining a mandatory securities valuation reserve. Companies not maintaining a mandatory securities valuation reserve shall value such stocks at market value.

b. Preferred or guaranteed stocks not in good standing are to be valued at market value.

c. Market value as used for valuation of preferred or guaranteed stocks means in accordance with the values listed in “Valuation of Securities.” For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed and not actively traded on a major stock exchange shall have a market value in an amount that the insurer can justify to the commissioner.

d. Preferred or guaranteed stocks of insurance subsidiaries are to be valued in accordance with the requirements of Section 31A-17-401(3)(a), U.C.A., and Section (4)(B) of this rule.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

(A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

(a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (i) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.

(b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.

(c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation

(1) Securities, other than those referred to in ° 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.
Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

(1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:

(a) Other than the nonadmissible exceptions listed in paragraph (2) of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners’ Valuation of Securities Task Force publication, Valuation of Securities, for the applicable year.

(b) Securities not listed in the National Association of Insurance Commissioners’ Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

Generally Accepted Accounting Principles

29. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. (Note: remainder of paragraph not reproduced as not applicable to preferred stock)

b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders’ equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders’ equity.
14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in the fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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4 A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.

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30. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
   b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
   c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entities and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:
   a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).
11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
   a. Derecognize all assets sold
   b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
   c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
   d. Recognize in earnings any gain or loss on the sale.
   The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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3Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

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12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:
   a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
      (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
      (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
   b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor’s right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.
   c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall
recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:
   a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
   c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
   d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
   e. For all servicing assets and servicing liabilities:
      (1) The amounts of servicing assets or liabilities recognized and amortized during the period
      (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
      (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
      (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.
25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity must meet both of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      (1) Holding title to transferred financial assets
      (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      (4) Distributing proceeds to the holders of its beneficial interests.
   b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entities and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.
28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
   b. Identical form and type so as to provide the same risks and rights
   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
   d. Identical contractual interest rates
   e. Similar assets as collateral
   f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

9In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the
parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"\textsuperscript{11} and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

\textsuperscript{11}If the "collateral" is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

64. The transferor of securities being "loaned" accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

**Illustration—Securities Lending Transaction Treated as a Secured Borrowing**

65. Accounting for a securities lending transaction treated as a secured borrowing:

**Facts**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transferor's carrying amount and fair value of security loaned</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cash &quot;collateral&quot;</td>
<td>1,020</td>
</tr>
<tr>
<td>Transferor's return from investing cash collateral at a 5 percent annual rate</td>
<td>5</td>
</tr>
<tr>
<td>Transferor's rebate to the borrower at a 4 percent annual rate</td>
<td>4</td>
</tr>
</tbody>
</table>

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.
**Journal Entries for the Transferor**

*At inception:*

Cash & 1,020  
Payable under securities loan agreements & 1,020  
To record the receipt of cash collateral

Securities loaned to broker & 1,000  
Securities & 1,000  
To reclassify loaned securities that cannot be redeemed on short notice

Money market instrument & 1,020  
Cash & 1,020  
To record investment of cash collateral

*At conclusion:*

Cash & 1,025  
Interest & 5  
Money market instrument & 1,020  
To record results of investment

Securities & 1,000  
Securities loaned to broker & 1,000  
To record return of security

Payable under securities loan agreements & 1,020  
Interest ("rebate") & 4  
Cash & 1,024  
To record repayment of cash collateral plus interest

**Journal Entries for the Transferee**

*At inception:*

Receivable under securities loan agreements & 1,020  
Cash & 1,020  
To record transfer of cash collateral

Securities & 1,000  
Obligation to return borrowed securities & 1,000  
To record receipt of borrowed securities that cannot be redeemed on short notice

*At conclusion:*

Obligation to return borrowed securities & 1,000  
Securities & 1,000  
To record the return of securities

Cash & 1,024  
Receivable under securities loan agreements & 1,020  
Interest revenue ("rebate") & 4  
To record the receipt of cash collateral and rebate interest
Repurchase Agreements and "Wash Sales"

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

OTHER SOURCES OF INFORMATION:

31. Accounting for Paid in Kind (PIK) Preferred Stocks (a form of redeemable preferred stock) is addressed in the NAIC Technical Resource Group Proposed Draft Life Codification:

PIK stocks are redeemable issues of preferred stock which have been used frequently in the financing of leveraged acquisitions because the dividends are payable either in cash or in additional shares of the identical securities for a specified period, typically three to five years (the "stock dividend period"). The choice of paying cash or securities is the election of the issuer; however, it is assumed that in most instances dividends will be paid in securities as a means of preserving cash after the leveraged acquisition. PIKs are redeemable after a fixed period, typically, 15 to 20 years, and a sinking fund may be used to fund redemption after the tenth. PIKs are typically callable; however, the call provisions vary. Some issues are callable at any time at par; others have call protection under which the issues are not callable until the fifth year, either at par or at a premium. PIKs typically are exchangeable at the issuer's election, either immediately or after a stated period, into junior subordinated debt or other securities of the issuer.

PIK bonds typically have the option at each interest payment date of making interest payments in cash or in additional debt securities. These additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds. Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

The method used by investors to account for investments in PIKs stocks and bonds should conform with the method used for investments in bonds and redeemable preferred stock. Therefore, the bond accounting method is appropriate because it is anticipated that dividends on PIKs will be paid in additional securities rather than cash (PIKs resemble zero coupon bonds). Accordingly, a form of level yield accounting similar to that used for zero coupons bonds is the preferable approach to recording income. Income under the level yield method is recognized by multiplying the level yield implicit in the PIK by the most recent balance sheet carrying amount.

Specifically, investments in PIK stocks should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.

Investments in PIK bonds should be recorded initially at cost and accreted to the lower of (1) the call price or (2) par value so that at final maturity the bond's carrying amount will be equal to the aggregate principal amount of the original bonds and all baby bonds received.

Any cash dividends paid during the stock dividend period on PIK stocks are accounted for as a reduction in the investment. Any interest paid on PIK bonds are accounted for as a reduction in the investment.

At no time should PIK securities be carried on the balance sheet in excess of the current call price. In addition, in the event of impairment in the value of the PIK, losses should be recognized immediately to the extent of the impairment.

If the PIKs are exchanged for other securities of the issuer, the carrying amount of the PIKs at the date of exchange becomes the cost basis of the new securities.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Accounting for Assets Transferred Between Affiliates and Chapter 2, Stocks
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 3 - Procedures for Determining NAIC Designations for Preferred Stocks
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liability, Loss Contingencies and Impairments of Assets
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Issue Paper No. 73 - Nonmonetary Transactions

Generally Accepted Accounting Principles
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions
- FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary’s Mandatorily Redeemable Preferred Stock

State Regulations
- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE Xxii-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments
- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation
- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

Other Sources of Information
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 1, Bonds
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Statutory Issue Paper No. 33

Disclosures about Fair Value of Financial Instruments

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Though disclosures about market values of certain investments are currently made in schedules included in the Annual Statements for Property and Casualty Insurance Companies and for Life and Accident and Health Insurance Companies, the annual statements contain no disclosures of fair values of other financial instruments. Furthermore, there are no specific disclosure requirements in the current statutory guidance requiring fair value disclosures in the financial statements. GAAP has specific disclosure requirements for the fair value of financial instruments. This issue paper establishes statutory accounting principles for disclosures about fair value of financial instruments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A financial instrument shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both:
   a. Imposes on one entity a contractual obligation (1) to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity;
   b. Conveys to that second entity a contractual right (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

3. Examples of the financial instruments, which encompass both assets and liabilities recognized and not recognized in the statement of financial position, to which this issue paper apply include but are not limited to short-term investments, bonds, common stock, preferred stocks, mortgage loans, derivatives, financial guarantees written, standby letters of credit, notes payable and deposit-type contracts.

4. A reporting entity shall disclose in the notes to the financial statements the fair value of all financial instruments, summarized by type of financial instrument, for which it is practicable to estimate fair value, except for certain financial instruments named in paragraph 8 of FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments (FAS 107), (which is excerpted in the Relevant GAAP Guidance section in paragraph 14 below). Fair value disclosed in the notes shall be presented together with the related admitted values in a form that makes it clear whether the fair values and admitted values represent assets or liabilities and to which line items in the Statement of Assets, Liabilities, Surplus and Other Funds they relate. Separate disclosure of this information in the notes is required even if such information is presented elsewhere in the financial statements. Unless specified otherwise in another issue paper the disclosures may be made net of encumbrances, if the asset or liability is so reported. A reporting entity shall also disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. For example, the notes should specify the reported value...
of investments using market prices published by the Securities Valuation Office of the NAIC (SVO) investments.

5. For purposes of this issue paper, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Market values published by the SVO, if available, shall always be the fair value amount disclosed. In the absence of SVO published market values or when amortized cost is used by the SVO as market value, quoted market prices by other third party organizations, if available, shall be used as the fair value of financial instruments. If neither SVO published market values nor quoted market prices are available, management’s best estimate of fair value shall be based on the quoted market price of a financial instrument with similar characteristics or on industry recognized valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved).

6. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:

   a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

   b. The reasons why it is not practicable to estimate fair value.

DISCUSSION

7. The conclusion above adopts FAS 107 as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FAS 119), except that paragraph 15(c) of FAS 119 relating to disclosure of financial instruments held or issued for trading is rejected. This is consistent with the conclusions in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities (CMOs), Issue Paper No. 30 - Investments in Common Stock, and Issue Paper No. 32 - Investments in Preferred Stock, in which FASB Statement No. 115, is rejected. This issue paper adopts FASB Emerging Issues Task Force No. 85-20, *Recognition of Fees for Guaranteeing a Loan*. Furthermore, this issue paper requires that if the SVO publishes a market value, that amount should be used in the fair value disclosures required by this issue paper.

8. This issue paper rejects FASB Statement No. 126, *Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities*, an amendment of FAS 107.

9. The Statement of Concepts states that:

   Because these basic financial statements cannot be expected to provide all of the information necessary to evaluate an entity’s short-term and long-term stability, management must supplement the financial statements with sufficient disclosures (e.g., notes to the financial statements, management’s discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.

Disclosures about fair values of financial instruments is consistent with that objective.

10. Current statutory accounting already recognizes the usefulness of fair value disclosures, and requires that disclosure of amounts for certain financial instruments in the Annual Statement schedules. The conclusion above expands this requirement to include disclosure in the notes to the financial statements of all financial instruments.
11. Paragraph 4 above requires the disclosure of the fair value of all financial instruments if it is practicable to estimate those values. In the context of this issue paper, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

12. Paragraph 8 of FAS 107, which is included in the Relevant GAAP Guidance section, discusses financial instruments which are exempt from fair value disclosure. Included as exempt instruments are insurance contracts, except for financial guaranty and investment contracts. Accordingly, the fair value disclosures should be made for guaranteed interest contracts (GICs), and liabilities associated with certain annuities and deposit accounts.

**Drafting Notes/Comments**
- Disclosure of concentration of credit risk is addressed in Issue Paper No. 27 - Disclosure of Information about Financial Instruments with Concentration of Credit Risk.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

13. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies require market values to be included in several invested asset schedules (e.g. Schedule A on real estate, Schedule BA on other long term assets, Schedule C on collateral loans, Schedule D on bonds, Schedule DB on options, caps and floors and Schedule DC on futures options). The schedules and the notes to the financial statement, however, do not contain market values for all investments or other financial instruments that are required by this issue paper.

**Generally Accepted Accounting Principles**

14. FAS 107 discusses fair value disclosures as follows:

3. A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both:

   a. Imposes on one entity a contractual obligation\(^1\) (1) to deliver cash or another financial instrument\(^2\) to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

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\(^1\) Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as liabilities in financial statements -- they may be “off-balance-sheet”--because they fail to meet some other criterion for recognition. For some financial instruments, the obligation is owed to or by a group of entities rather than a single entity.

\(^2\) The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual
obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

b. Conveys to that second entity a contractual right\(^3\) (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

\(^3\) Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements -- may be “off-balance-sheet”--because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

4. The definition in paragraph 3 is essentially the same as that in paragraph 6 of Statement 105, which is hereby amended to conform to this Statement. Appendix A of Statement 105 provides examples of instruments that are included in and excluded from the definition of a financial instrument.

5. For purposes of this Statement, the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.

6. Under the definition of fair value in paragraph 5, the quoted price for a single trading unit in the most active market is the basis for determining market price and reporting fair value. This is the case even if placing orders to sell all of an entity’s holdings of an asset or to buy back all of a liability might affect the price, or if a market’s normal volume for one day might not be sufficient to absorb the quantity held or owed by an entity.

7. This Statement requires disclosures about fair value for all financial instruments, whether recognized or not recognized in the statement of financial position, except for those specifically listed in paragraph 8. It applies to all entities. It does not change any requirements for recognition, measurement, or classification of financial instruments in financial statements.

8. The disclosures about fair value prescribed in paragraphs 10-14 are not required for the following:

a. Employers’ and plans’ obligations for pension benefits, other postretirement benefits including health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements, as defined in FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers’ Accounting for Pensions, No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions, and No. 43, Accounting for Compensated Absences, and APB Opinions No. 25, Accounting for Stock Issued to Employees, and No. 12, Omnibus Opinion -- 1967

b. Substantively extinguished debt subject to the disclosure requirements of FASB Statement No. 76, Extinguishment of Debt, and assets held in trust in connection with an in-substance defeasance of that debt.

c. Insurance contracts, other than financial guarantees and investment contracts, as discussed in FASB Statements No. 60, Accounting and Reporting by
Insurance Enterprises, and No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

d. Lease contracts as defined in FASB Statement No. 13, Accounting for Leases (a contingent obligation arising out of a canceled lease and a guarantee of a third-party lease obligation are not lease contracts and are included in the scope of this Statement)

e. Warranty obligations and rights

f. Unconditional purchase obligations as defined in paragraph 6 of FASB Statement No. 47, Disclosure of Long-Term Obligations

g. Investments accounted for under the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock

h. Minority interests in consolidated subsidiaries

i. Equity investments in consolidated subsidiaries

j. Equity instruments issued by the entity and classified in stockholders’ equity in the statement of financial position.

9. Generally accepted accounting principles already require disclosure of or subsequent measurement at fair value for many classes of financial instruments. Although the definitions or the methods of estimation of fair value vary to some extent, and various terms such as market value, current value, or mark-to-market are used, the amounts computed under those requirements satisfy the requirements of this Statement and those requirements are not superseded or modified by this Statement.

Disclosures about Fair Value of Financial Instruments

10. An entity shall disclose, either in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. An entity also shall disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

11. Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management’s best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).

12. In estimating the fair value of deposit liabilities, a financial entity shall not take into account the value of its long-term relationships with depositors, commonly known as core deposit intangibles, which are separate intangible assets, not financial instruments. For deposit liabilities with no defined maturities, the fair value to be disclosed under this Statement is the amount payable on demand at the reporting date. This Statement does not prohibit an entity from disclosing separately the estimated fair value of any of its nonfinancial intangible and tangible assets and nonfinancial liabilities.

13. For trade receivables and payables, no disclosure is required under this Statement when the carrying amount approximates fair value.

14. If it is not practicable for an entity to estimate the fair value of a financial instrument or a class of financial instruments, the following shall be disclosed:
a. Information pertinent to estimating the fair value of that financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity

b. The reasons why it is not practicable to estimate fair value.

15. In the context of this Statement, practicable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another. For example, it might not be practicable for an entity to estimate the fair value of a class of financial instruments for which a quoted market price is not available because it has not yet obtained or developed the valuation model necessary to make the estimate, and the cost of obtaining an independent valuation appears excessive considering the materiality of the instruments to the entity. Practicability, that is, cost considerations, also may affect the required precision of the estimate; for example, while in many cases it might seem impracticable to estimate fair value on an individual instrument basis, it may be practicable for a class of financial instruments in a portfolio or on a portfolio basis. In those cases, the fair value of that class or of the portfolio should be disclosed. Finally, it might be practicable for an entity to estimate the fair value only of a subset of a class of financial instruments; the fair value of that subset should be disclosed.

15. During 1994, the FASB issued FAS 119 which amended FAS 107 as follows:

15. Statement 107 is amended as follows:

a. In paragraph 10, the following footnote is added after either in the body of the financial statements or in the accompanying notes:

* If disclosed in more than a single note, one of the notes shall include a summary table. The summary table shall contain the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by this Statement, as amended.

b. In paragraph 10, the following is added after the first sentence:

Fair value disclosed in the notes shall be presented together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position.

c. The following is added to the end of paragraph 10:

The disclosures shall distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading.

d. The following paragraph and footnote are added after paragraph 13:

In disclosing the fair value of a derivative financial instrument,** an entity shall not (a) combine, aggregate, or net that fair value with the fair value of nonderivative financial instruments or (b) net that fair value with the fair value of other derivative financial instruments -- even if those nonderivative or derivative financial instruments are considered to be related, for example, by a risk management strategy -- except to the extent that the offsetting of carrying amounts in the statement of financial position is permitted under the general principle in paragraphs 5 and 6 of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, or the exception for master netting arrangements in paragraph 10 of Interpretation 39.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies

Generally Accepted Accounting Principles
- FASB Statement No. 107, Disclosure about Fair Value of Financial Instruments
- FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments
- FASB Statement No. 126, Exemptions from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities, an amendment of FAS 107
- FASB Emerging Issues Task Force No. 85-20, Recognition of Fees for Guaranteeing a Loan

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 34

Investment Income Due and Accrued

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance pertaining to accounting for investment income due and accrued is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. The purpose of this paper is to establish statutory accounting principles for investment income due and accrued which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. Investment income due shall be defined as investment income earned and legally due to be paid to the reporting entity (i.e., receivable) as of the reporting date. Investment income accrued shall be defined as investment income earned as of the reporting date but not legally due to be paid to the reporting entity until subsequent to the reporting date.

3. In general, gross investment income shall be recorded as earned and shall include investment income collected during the period, the change in investment income due and accrued, the change in unearned investment income plus any amortization (e.g., discounts or premiums on bonds, origination fees on mortgage loans, etc.). Additional guidance on investment income recognition relative to specific types of investments is provided in issue papers on each specific type of investment.

4. Investment income due and accrued shall be recorded as an asset in accordance with Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). An evaluation shall be made of such assets in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), to determine whether an impairment exists. Amounts determined to be uncollectible shall be written off through the statement of operations. Then an evaluation shall be made to determine nonadmitted amounts.

This two step process is set forth below.

a) Investment income due and accrued shall be assessed for collectibility. If, in accordance with Issue Paper No. 5, it is probable the investment income due and accrued balance is uncollectible, the amount shall be written off and shall be charged against investment income in the period such determination is made.

b) Any remaining investment income due and accrued (i.e., amounts considered probable of collection) representing either (1) amounts that are over 90 days past due (generated by any invested asset except mortgage loans in default), or (2) amounts designated elsewhere in the codification as nonadmitted shall be considered nonadmitted assets and recognized through a direct charge to surplus in accordance with Issue Paper No. 4. These nonadmitted amounts shall be subject to continuing assessments of collectibility and, if determined to be uncollectible, a write-off shall be recorded in the period such determination is made in accordance with subparagraph a) above.
5. Accrued interest on mortgage loans that are in default (as defined in Issue Paper No. 37 - Mortgage Loans) shall be recorded as Investment Income Due and Accrued when such interest is deemed collectible. Interest can be accrued on mortgage loans in default if deemed collectible; if interest is deemed uncollectible, it shall not be accrued and any previously accrued amounts are to be written off in accordance with the guidelines in paragraph 4a above. If a loan in default has interest 180 days past due which has been assessed as collectible, all interest shall be considered a non-admitted asset and recognized through a direct charge to surplus as outlined in paragraph 4(b) above.

6. The following disclosures shall be made for investment income due and accrued in the notes to the financial statements.

   - The bases by category of investment income for excluding (nonadmitting) any investment income due and accrued
   - Disclose total amount excluded.

DISCUSSION

7. The Statutory Accounting Principles outlined in the conclusion above are consistent with current statutory accounting guidance for investment income due and accrued, except for the following:

   - Current statutory accounting states that “Income due, which is doubtful collectibility, should either not be accrued or should be treated as nonadmitted”. However, the conclusion above requires that such amounts be accrued as earned and then written off in the period in which the determination is made that the amounts are uncollectible.

   - Current statutory guidance states that accrued rent on real estate three months or more be treated as a nonadmitted asset. The conclusion above requires that accrued rent be assessed for collectibility and any uncollectible amounts written off in the period in which the determination is made that the amounts are uncollectible. Any remaining accrued rent past due three months or more (but determined to be collectible) shall be treated as a nonadmitted asset.

   - Current statutory guidance states that accrued interest on mortgage loans past due twelve months or more be treated as a nonadmitted asset and accrued interest on loans in default, being voluntarily conveyed, or being foreclosed be added to the carrying value if such amounts are deemed to be recoverable from the ultimate disposition of the property. The conclusion above requires an assessment of the collectibility of the interest to determine if such should be accrued or written off. If the loan in default has interest which is 180 days past due and deemed to be collectible, all interest on the defaulted loan shall be considered a nonadmitted asset.

8. The statutory accounting principle outlined in the conclusion above accounts for investment income due and accrued in a manner consistent with the Statement of Concepts recognition concept which states that “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed”. It recognizes any impairment (i.e., doubtful collection) of the asset in the period in which such a determination occurs in accordance with Issue Paper No. 5.

9. The Statement of Concepts also states:

   Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interest should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
10. Based on the above concept, investment income due and accrued should reflect only amounts that are available to meet policyholder obligations. Consistent with the conservatism concept, amounts for which collection is past due by a specified number of months, but for which the ultimate collection is not considered doubtful, should be recognized as nonadmitted assets through a direct charge against surplus in accordance with Issue Paper No. 4.

Drafting Notes/Comments
- Accounting for common and preferred stock holdings of subsidiary, controlled and affiliated entities will be addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Accounting for joint ventures and partnerships will be addressed in Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies.
- Accounting for recognition of investment income is addressed in separate issue papers on each type of investment.
- Accounting for investments in surplus notes is addressed in a separate issue paper.
- Accounting for mortgage loans, including valuation, is addressed in Issue Paper No. 37 - Mortgage Loans.
- Accounting for policy loans is addressed in Issue Paper No. 49 - Policy Loans.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
11. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to unearned investment income and investment income due and accrued. Similar guidance is found in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies. Pertinent excerpts from the Life and Accident and Health manual are as follows:

CHAPTER 19
INVESTMENT INCOME AND NET REALIZED GAINS

Investment Income Due

Income due represents certain amounts of income which are legally owed to the company as of the statement date but have not yet been received. Income due, which is doubtful collectibility, should either not be accrued or should be treated as nonadmitted. On certain bonds in default, the company should not report interest due because the association value of the bond includes such interest.

Accrued Investment Income

Income accrued represents interest that would be collectible if the obligation were to mature as of the statement date. The amounts that are shown as accrued for preferred stocks and common stocks are dividends on stocks declared to be ex-dividend on or prior to the statement date and payable after that date.

Nonadmitted Investment Income

Nonadmitted income represents any of the above-noted types of investment income reported as due or accrued if it is of doubtful collectibility. The company should not take credit for this as income. This is of particular importance regarding mortgage loans with interest that is past due twelve months or more and real estate with rents past due three months or more. These receivables should be deducted as nonadmitted.
12. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides additional guidance with respect to interest income on bonds and loan-backed and structured securities. Pertinent excerpts are as follows:

CHAPTER 1

Bonds and Loaned Backed and Structured Securities
Interest income

If interest (including contingent interest) on a bond is recorded when received, an adjustment must be made to recognize due and accrued interest as of the reporting date. Interest income for any period consists of interest collected during the period and the change in the due and accrued interest between the beginning and end of the period, plus the adjustments for the accrual of discount, minus adjustment for the amortization of premium, and minus adjustment for interest paid on acquisition of bonds.

Contingent interest represents bondholder income generated through the occurrence of specific economic events in relation to the issuer. For example, contingent interest may become payable upon the attainment by the issuer of a given level of cash flow or income. In many respects, bonds with contingent interest provisions are similar to income bonds. Due and unpaid contingent interest may be recorded as income. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.


14. The Accounting Practices and Procedures Manual for Life and Accident and Health and Property and Casualty Insurance Companies provides additional guidance with respect to dividends. Pertinent excerpts are as follows:

CHAPTER 2
STOCKS

Dividends

Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The Valuation of Securities manual has a complete listing of all stocks that are traded “ex-dividend” at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

15. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to mortgage loan interest income. Pertinent excerpts are as follows:
CHAPTER 3
MORTGAGE LOANS

Interest

Interest income on mortgage loans is recorded when earned during the any reporting period. An “inventory” of due and accrued interest must be determined at the end of each reporting period. Interest income includes adjustments for amortization or the accrual of discount.

A portion of the interest due and accrued on mortgage loans may require treatment as a nonadmitted asset for reporting purposes. In general, amounts over one year past due are nonadmitted. In practice, some companies consider that interest past due for periods of less than one year indicates future uncollectibility, and may make a provision against operations for such amounts to establish an appropriate reserve. Alternatively, some companies may cease accrual of interest on loans that default on any payment. Therefore, the amount of due and accrued interest that is considered to be a nonadmitted asset depends on the policy regarding accrual determination, and whether reserves have been established by charges to operations. In the case of mortgage loans on which foreclosure action is pursued, delinquent interest may be recovered from the amount, if any, by which the proceeds on the eventual sale of the property exceed the unpaid principal balance.

Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Payments

Payments on mortgage loans may be received in advance of due dates. Such payments may produce prepaid interest which is considered unearned and is recorded as a liability in the annual statement.

Companies that use servicing agents for their mortgage loans should report the "Interest Due and Accrued" asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet should be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued should be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.


17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to real estate investment income. Pertinent excerpts are as follows:

CHAPTER 4
REAL ESTATE

Income Derived from Real Estate

Income on real estate, or on space in buildings owned and occupied by the company, usually is received periodically and in advance and any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount
applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a period specified by statute or regulation, most jurisdictions require that the entire amount be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part should be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received should be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the rental income for the period.


19. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to interest income on cash on deposit. Pertinent excerpts are as follows:

CHAPTER 5
CASH AND SHORT-TERM INVESTMENTS

Income from Bank Deposits

Income consists of the interest that is earned on interest-bearing bank deposits and on demand certificates of deposit. Earned interest consists of interest that is collected during the period, plus due or accrued interest at the end of the period, minus any unearned interest, and minus due or accrued interest, plus any unearned interest at the beginning of the period.

The amount allowed as an admitted asset for due or accrued interest is the interest or dividends due and payable, but not credited, on deposits in banks and trust companies or on accounts with savings and loans associations.

The accrued interest on savings accounts is admissible because, if the deposit was withdrawn at the statement date, interest would be paid to the date of withdrawal. Accrued interest on demand CD’s may be wholly or partially not admitted in some states, as interest is payable at maturity and, if the certificates are redeemed early, an interest penalty may be assessed. The certificate must be examined to determine the status of accrued interest. If the certificate were to be redeemed before maturity, and the interest would be payable, the accrued interest may be admitted but not in an amount that exceeds that amount receivable if redeemed prior to maturity. The maximum amount of accrued interest that may be admitted on a certificate which provides for an interest penalty for early redemption is based upon a reduced interest rate.


21. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to interest income on policy loans. Pertinent excerpts are as follows:

CHAPTER 7
POLICY LOANS

Interest

Interest on a policy loan may be payable at either the beginning or end of the policy loan interest period. Where it is payable at the beginning of the period, appropriate balance sheet provision should be established for any unearned policy loan interest. Where it is payable at the end of the period, appropriate provision should be established for any accrued interest. Interest earned is reported as investment income.
The calculation of investment income from a company’s policy loans requires a determination of unearned or accrued interest. These are included in their respective accounts in the balance sheet as unearned or accrued investment income and not with the balance of policy loans. The calculation of accrued and unearned interest usually is made on a policy-by-policy basis, or for policies grouped by interest rate and policy anniversary or interest paid-to-date.

Past-due interest normally is capitalized as an addition to the loan balance with the interest recorded as received.

22. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides the following in its list of admitted assets in Chapter 8:

(k) Interest, Dividends and Real Estate Income Due and Accrued

1. The rents accrued and owing to the company on real and personal property, directly or beneficially owned
2. Interest or rents accrued on conditional sales agreements, chattel mortgages and real or personal property under lease to other corporations
3. The fixed and required interest due and accrued on bonds and other like evidences of indebtedness, not in default
4. Dividends receivable on shares of stock, provided that the market price taken for valuation purposes does not include the value of the dividend
5. The interest or dividends due and accrued, but not credited, on deposits in banks and trust companies or on accounts with savings and loan associations
6. Interest accrued on tax anticipation warrants
7. Interest accrued on secured loans

23. The Iowa state regulations provide the following guidance:

In estimating the profits, a reserve for unearned premiums as set out in section 515.47, also a reserve for unpaid losses, expenses, and taxes which have been incurred shall be set up; and there shall also be held as nonadmitted assets all sums due the corporation on bonds and mortgages, bonds, stocks, and book accounts, of which no part of the principal or interest thereon has been paid during the year preceding such estimate of profits, and upon which suit for foreclosure or collection has not been commenced, or which, after judgment has been obtained thereon, shall have remained more than two years unsatisfied, and on which interest has not been paid; and such judgment with the interest due or accrued thereon and remaining unpaid, shall also be so held.

Generally Accepted Accounting Principles
24. There is no specific GAAP guidance that addresses unearned investment income or investment income due and accrued.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities, Chapter 2, Stocks, Chapter 3, Mortgage Loans, Chapter 4, Real Estate, Chapter 5, Cash and Short-Term Investments, Chapter 7, Policy Loans, Chapter 19, Investment Income and Net Realized Gains
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities, Chapter 2, Stocks, Chapter 3, Mortgage Loans, Chapter 4, Real Estate, Chapter 5, Cash and Short-Term Investments, Chapter 8, Other Admitted Assets, Chapter 15, Investment Income

**Generally Accepted Accounting Principles**
- No applicable GAAP guidance

**State Regulations**
- Iowa Statutes - Insurance Laws, TITLE XIII--COMMERCE, Subtitle 1. Insurance and Related Regulation, Chapter 515 --INSURANCE OTHER THAN LIFE, General Provisions, 515.45 Reserves
Statutory Issue Paper No. 35

Accounting for Guaranty Fund and Other Assessments

STATUS
Finalized December 6, 1999

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Guaranty fund assessments represent a funding mechanism employed by state insurance departments to provide funds to cover policyholder obligations of insolvent reporting entities. Most states have enacted legislation establishing guaranty funds for both life and health insurance and for property and casualty insurance to provide for covered claims or to meet other insurance obligations of insolvent insurers in the state. Guaranty funds generally make assessments after an insolvency based upon retrospective premium writings for Life and Accident and Health Insurance Companies or prospective premium writings for Property and Casualty Insurance Companies. However, a small number of states have guaranty funds that prefund, that is they assess members before an insolvency occurs. Reporting entities are subject to a variety of other assessments, such as workers compensation second-injury funds and funds that pay operating costs of the insurance department, health related assessments, or the workers compensation board.

2. State laws often allow for recoveries of guaranty fund assessments through refunds from the guaranty fund, premium tax credits, policy surcharges, and future premium rate structures.

3. Current statutory accounting provides only limited guidance on accounting for guaranty fund and other assessments; requiring that assessments be charged to taxes, licenses and fees, but not addressing when to recognize liabilities for assessments. SOP 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments (SOP 97-3) dictates GAAP guidance. This issue paper establishes statutory accounting principles for guaranty fund and other assessments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), requires accrual of a liability when both of the following conditions are met:

   a. Information available prior to issuance of the statutory financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the statutory financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability, and

   b. The amount of loss can be reasonably estimated.

For purposes of subparagraph 4 b., loss generally means assessment or assessment rate. Guaranty fund and other assessments shall be charged to expense (Taxes, Licenses and Fees) and a liability shall be accrued when those criteria are met except for certain health related assessments which shall be reported as a part of claims. Health related assessments that are reported as a part of claims instead of taxes, licenses and fees are those assessments that are designed for the purpose of spreading the risk of severe claims or adverse enrollment selection among all participating entities, and where the funds collected via
the assessment are re-distributed back to the participating entities based upon the cost of specific claims, enrollment demographics, or other criteria affecting health care expenses.

5. For refunded guaranty fund assessments and assessments used to fund state operating expenses, reporting entities shall credit the refund or charge the assessment to expense when notification of the refund or assessment is made.

6. For guaranty fund assessments, subparagraph 4a is met when the insolvency has occurred, regardless of whether the assessments are based on premiums written before or after the insolvency. For purposes of applying this guidance, the insolvency shall be considered to have occurred when a reporting entity meets a state's (ordinarily the state of domicile of the insolvent reporting entity) statutory definition of an insolvent reporting entity. In most states, the reporting entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Loss-based administrative-type and second injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

7. Subparagraph 4b requires that the amounts can be reasonably estimated. For guaranty fund or other assessments, a reporting entity's estimate of the liability shall reflect an estimate of its share of the ultimate loss expected from the insolvency. The reporting entity shall also make any applicable premium tax credits and policy surcharges. An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of future assessments. Estimates of loss-based assessments should be consistent with estimates of the underlying losses and should be developed based upon enacted laws or regulations and expected assessment rates. Premium tax credits or policy surcharges may only be considered in the estimate if it is probable they will be realized. Changes in the amount of the liability (or asset) as a result of the passage of time and revisions to estimates in the amount or timing of the payments shall be recorded in taxes, licenses and fees.

8. In accordance with Issue Paper No. 5, when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. When, in management’s opinion, no amount within management’s estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of within management’s estimate in the range shall be accrued. For purposes of this issue paper, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be accrued.

9. The liability for assessments shall be established gross of any probable and estimable recoveries from premium tax credits and premium surcharges. Because assessments are generally paid before premium tax credits are realized or policy surcharges are collected, an asset may result, which represents a receivable for premium tax credits that will be taken and policy surcharges which will be collected in the future. These amounts, to the extent it is probable they will be realized, meet the definition of assets, as specified in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4), and are admitted assets to the extent they conform to the requirements of this issue paper. The asset shall be established and reported independent from the liability (not reported net).

10. In certain circumstances, a reporting entity acts as an agent for certain state agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the reporting entity. The reporting entity’s
obligation is to collect and subsequently remit the fee or assessment. When both the following conditions are met, an assessment should not be reported in the statement of operations of a reporting entity:

a. The assessment is reflected as a separately identifiable item on the billing to the policyholder; and

b. Remittance of the assessment by the reporting entity to the state is contingent upon collection from the insured.

Disclosure
11. In the event that the criteria in paragraph 4 are not met, the notes to the financial statements shall include the disclosure required by Issue Paper No. 5 which, indicates the nature of the assessments and states that an estimate of the liability cannot be made.

DISCUSSION
12. This issue paper applies Issue Paper No. 5 to guaranty fund and other assessments.

13. Current statutory practice is that assessments for life guaranty fund obligations (which are based on premiums written prior to the insolvency) are accrued at the time of the insolvency. Current statutory practice for property and casualty guaranty fund assessments varies. Not all property and casualty guaranty fund obligations are accrued at the time of the insolvency. Those that have not accrued the obligation believe that guaranty fund assessments that are based on premiums written after an insolvency should be accrued when the premiums are written, because the event that obligates the company is the writing of the premiums. This issue paper rejects that point of view, because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. With respect to conservatism, the Statement of Concepts states that:

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management ... In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

With respect to recognition, the Statement of Concepts states that:

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies... Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

Drafting Notes/Comments
- Voluntary Guaranty Funds should be accounted for in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
14. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies mention guaranty fund surplus in their respective chapters on surplus. Both state that “Guaranty fund surplus for mutual companies” should be considered as part of surplus, for purposes of meeting the minimum surplus requirements.

15. The NAIC Annual Statement Instructions indicate that Taxes, Licenses & Fees should include guaranty fund assessments.
16. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force discussed the accounting for guaranty fund and other assessments in Issues 91-1 through 91-4 and 92-1. The discussion focused around whether guaranty fund assessments could be reported as loss payments. The consensus reached was that guaranty fund assessments should be reported as expense items through Taxes, Licenses and Fees.

17. The Life and Health Insurance Guaranty Association Model Act provides the following guidance:

Section 9. Assessments

A. For the purpose of providing the funds necessary to carry out the powers and duties of the Association, the board of directors shall assess the member insurers, separately for each account, at such time and for such amounts as the board finds necessary. Assessments shall be due not less than thirty (30) days after prior written notice to the member insurers and shall accrue interest at [insert amount] percent per annum on and after the due date.

B. There shall be two (2) assessments, as follows:

(1) Class A assessments shall be made for the purpose of meeting administrative and legal costs and other expenses and examinations conducted under the authority of Section 12E. Class A assessments may be made whether or not related to a particular impaired or insolvent insurer.

(2) Class B assessments shall be made to the extent necessary to carry out the powers and duties of the Association under Section 8 with regard to an impaired or an insolvent insurer.

C. (1) The amount of any Class A assessment shall be determined by the board and may be made on a pro rata or non-pro rata basis. If pro rata, the board may provide that it be credited against future Class B assessments. A non-pro rata assessment shall not exceed $150 per member insurer in any one calendar year. The amount of any Class B assessment shall be allocated for assessment purposes among the accounts pursuant to an allocation formula which may be based on the premiums or reserves of the impaired or insolvent insurer or any other standard deemed by the board in its sole discretion as being fair and reasonable under the circumstances.

(2) Class B assessments against member insurers for each account and subaccount shall be in the proportion that the premiums received on business in this state by each assessed member insurer or policies or contracts covered by each account for the three (3) most recent calendar years for which information is available preceding the year in which the insurer became impaired or insolvent, as the case may be, bears to such premiums received on business in this state for such calendar years by all assessed member insurers.

(3) Assessments for funds to meet the requirements of the Association with respect to an impaired or insolvent insurer shall not be made until necessary to implement the purposes of this Act. Classification of assessments under Subsection B and computation of assessments under this subsection shall be made with a reasonable degree of accuracy, recognizing that exact determinations may not always be possible.

D. The Association may abate or defer, in whole or in part, the assessment of a member insurer if, in the opinion of the board, payment of the assessment would endanger the ability of the member insurer to fulfill its contractual obligations. In the event an assessment against a member insurer is abated, or deferred in whole or in part, the amount by which the assessment is abated or deferred may be assessed against the
other member insurers in a manner consistent with the basis for assessments set forth in this section.

E. (1) The total of all assessments upon a member insurer for the life and annuity account and for each subaccount thereunder shall not in any one calendar year exceed two percent (2%) and for the health account shall not in any one calendar year exceed two percent (2%) of the insurer's average premiums received in this state on the policies and contracts covered by the account during the three (3) calendar years preceding the year in which the insurer became an impaired or insolvent insurer. If the maximum assessment, together with the other assets of the Association in any account, does not provide in any one year in either account an amount sufficient to carry out the responsibilities of the Association, the necessary additional funds shall be assessed as soon thereafter as permitted by this Act.

(2) The board may provide in the plan of operation a method of allocating funds among claims, whether relating to one or more impaired or insolvent insurers, when the maximum assessment will be insufficient to cover anticipated claims.

(3) If a one percent (1%) assessment for any subaccount of the life and annuity account in any one year does not provide an amount sufficient to carry out the responsibilities of the Association, then pursuant to Subsection C(2), the board shall access all subaccounts of the life and annuity account for the necessary additional amount, subject to the maximum stated in Subsection E(1) above.

Editor's Note: For interpretation of this section, see Guaranty Fund (EX4) Task Force minutes in 1988 Proceedings of the NAIC, Volume II, page 335.

F. The board may, by an equitable method as established in the plan of operation, refund to member insurers, in proportion to the contribution of each insurer to that account, the amount by which the assets of the account exceed the amount the board finds is necessary to carry out during the coming year the obligations of the Association with regard to that account, including assets accruing from assignment, subrogation, net realized gains and income from investments. A reasonable amount may be retained in any account to provide funds for the continuing expenses of the Association and for future losses.

G. It shall be proper for any member insurer, in determining its premium rates and policyowner dividends as to any kind of insurance within the scope of this Act, to consider the amount reasonably necessary to meet its assessment obligations under this Act.

H. The Association shall issue to each insurer paying an assessment under this Act, other than Class A assessment, a certificate of contribution, in a form prescribed by the Commissioner for the amount of the assessment so paid. All outstanding certificates shall be of equal dignity and priority without reference to amounts or dates of issue. A certificate of contribution may be shown by the insurer in its financial statement as an asset in such form and for such amount, if any, and period of time as the Commissioner may approve.

Comment: When an insurer is impaired or insolvent the member insurers will be assessed on the basis of the premiums they write in the state. This corresponds to the Association's liability which, in most cases, is limited to covered policies of residents. This assessment system provides a base broad enough to meet fairly large demands on the Association. Equally important, since it reflects the market share of each member in the state considered, it is an equitable method of apportioning the burden of the assessments.

The maximum assessment per year may be varied from state to state depending on the size of the base and the concentration of the business. The two percent maximum assessment per year
should produce an adequate amount while at the same time not impose an undue strain in any given year on the assessed companies and their policyholders.

In order to prevent further financial difficulties caused by an assessment, Subsection D permits abatement of assessments when such financial difficulties might result. Subsections D and E provide some limitation on the amounts which can be assessed in any given year. If these limits are reached, to fulfill its responsibilities the Association is empowered to borrow funds which later can be repaid out of future assessments.

Subsection G provides that a member insurer may consider in its premium rates and dividend scale an amount reasonably necessary to meet its assessment obligations. This makes it clear that the cost can be ultimately passed on to the policyowners - i.e., to persons who enjoy the protection provided by the Act.

Subsection H provides that the Association shall issue to assessed insurers certificates of contribution in the amount levied. The certificates may be carried by an insurer in its annual statement as an asset in such form, amount and period as may be approved by the Commissioner. By permitting the companies to carry these certificates as an asset, to the extent of their estimated value, the impact on member insurers will be lessened.

18. The Post-Assessment Property and Liability Insurance Guaranty Association Model Act provides the following guidance:

Section 8. Powers and Duties of the Association

A. The Association shall:

(1) Be obligated to pay covered claims existing prior to the determination of the insolvency arising within thirty (30) days after the determination of insolvency, or before the policy expiration date if less than thirty (30) days after the determination of insolvency, or before the insured replaces the policy or causes its cancellation, if he does so within thirty (30) days of the determination. The obligation shall be satisfied by paying to the claimant an amount as follows:

(a) The full amount of a covered claim for benefits under a workers compensation insurance coverage;
(b) An amount not exceeding $10,000 per policy for a covered claim for the return of unearned premium;
(c) An amount not exceeding $300,000 per claimant for all other covered claims.

In no event shall the Association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy or coverage from which the claim arises. Notwithstanding any other provisions of this Act, a covered claim shall not include any claim filed with the Guaranty Fund after the final date set by the court for the filing of claims against the liquidator or receiver of an insolvent insurer. The Association shall pay only that amount of each unearned premium which is in excess of $100.

Comment: The obligation of the Association is limited to covered claims unpaid prior to insolvency, and to claims arising within thirty days after the insolvency, or until the policy is canceled or replaced by the insured, or it expires, whichever is earlier. The basic principle is to permit policyholders to make an orderly transition to other companies. There appears to be no reason why the Association should become in effect an insurer in competition with member insurers by continuing existing policies, possibly for several years. It is also felt that the control of the
policies is properly in the hands of the liquidator. Finally, one of the major objections of the public to rapid termination, loss of unearned premiums with no corresponding coverage, is ameliorated by this bill since unearned premiums are permissible claims, up to $10,000, against the Association. The deductible amount ($100) and the maximums ($10,000 for the return of unearned premium; $300,000 for all other covered claims) represent the subcommittee’s concept of practical limitations, but each state will wish to evaluate these figures.

[Alternate Section 8A(1)]

A. The Association shall:

1. Be obligated to pay covered claims existing prior to the determination of the insolvency arising within thirty (30) days after the determination of insolvency, or before the policy expiration date if less than thirty (30) days after the determination of insolvency, or before the insured replaces the policy or causes its cancellation, if he does so within thirty (30) days of the determination. The obligation shall extend to covered claims reported pursuant to an optional extended period to report claims sold to the insured by the liquidator. The obligation as to covered claims shall be satisfied by paying to the claimant an amount as follows:

   a. The full amount of a covered claim for benefits under a workers compensation insurance coverage;

   b. An amount not exceeding $10,000 per policy for a covered claim for the return of unearned premium;

   c. An amount not exceeding $300,000 per claimant for all other covered claims.

In no event shall the Association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy from which the claim arises. Notwithstanding any other provision of this Act, a covered claim shall not include any claim filed with the Guaranty Fund after the earlier of the final date for the filing of claims against the liquidator or receiver of an insolvent insurer or eighteen (18) months after the order of liquidation. The Association shall pay only that amount of each unearned premium which is in excess of $100.

Comment: The Alternate Section 8A(1) should be used if the state includes a provision in its liquidation law giving the liquidator authority to sell a limited extended reporting period for claims-made policies.

2. Be deemed the insurer to the extent of its obligation on the covered claims and to that extent shall have all rights, duties and obligations of the insolvent insurer as if the insurer had not become insolvent.

3. Assess insurers amounts necessary to pay the obligations of the Association under Section 8A(1) subsequent to an insolvency, the expenses of handling covered claims subsequent to an insolvency, and other expenses authorized by this Act. The assessments of each member insurer shall be in the proportion that the net direct written premiums of the member insurer for the calendar year preceding the assessment bears to the net direct written premiums of all member insurers for the calendar year preceding the assessment. Each member insurer shall be notified of the assessment not later than thirty (30) days before it is due. No member insurer may be assessed in any year an amount greater than two percent (2%) of that member insurer’s net direct written premiums for the
calendar year preceding the assessment. If the maximum assessment, together with the other assets of the Association, does not provide in any one year an amount sufficient to make all necessary payments, the funds available shall be prorated and the unpaid portion shall be paid as soon thereafter as funds become available. The Association shall pay claims in any order which it may deem reasonable, including the payment of claims as they are received from the claimants or in groups or categories of claims. The Association may exempt or defer, in whole or in part, the assessment of any member insurer, if the assessment would cause the member insurer's financial statement to reflect amounts of capital or surplus less than the minimum amounts required for a certificate of authority by any jurisdiction in which the member insurer is authorized to transact insurance; provided, however, that during the period of deferral, no dividends shall be paid to shareholders or policyholders. Deferred assessments shall be paid when the payment will not reduce capital or surplus below required minimums. Payments shall be refunded to those companies receiving larger assessments by virtue of such deferment, or at the election of the company, credited against future assessments.

[Alternate Section 8A(3)]

Allocate claims paid and expenses incurred among the three (3) accounts separately, and assess member insurers separately for each account, amounts necessary to pay the obligations of the Association under Section 8A(1) subsequent to an insolvency, the expenses of handling covered claims subsequent to an insolvency and other expenses authorized by this Act. The assessments of each member insurer shall be in the proportion that the net direct written premiums of the member insurer for the calendar year preceding the assessment on the kinds of insurance in the account bears to the net direct written premiums of all member insurer's for the calendar year preceding the assessment on the kinds of insurance in the account. Each member insurer shall be notified of the assessment not later than thirty (30) days before it is due. No member insurer may be assessed in any one year on any account an amount greater than two percent (2%) of that member insurer's net direct written premiums for the calendar year preceding the assessment on the kinds of insurance in the account. If the maximum assessment, together with the other assets of the Association in any account, does not provide in any one year in any account an amount sufficient to make all necessary payments from that account, the funds available shall be pro-rated and the unpaid portion shall be paid as soon thereafter as funds become available. The Association shall pay claims in any order which it deems reasonable, including the payment of claims as they are received from the claimants or in groups or categories of claims. The Association may exempt or defer, in whole or in part, the assessment of any member insurer, if the assessment would cause the member insurer's financial statement to reflect amounts of capital or surplus less than the minimum amounts required for a certificate of authority by any jurisdiction in which the member insurer is authorized to transact insurance; provided, however, that during the period of deferral, no dividends shall be paid to shareholders or policyholders. Deferred assessments shall be paid when the payment will not reduce capital or surplus below required minimums. Payments shall be refunded to those companies receiving larger assessments by virtue of such deferment, or at the election of the company, credited against future assessments. Each member insurer may set off against any assessment, authorized payments made on covered claims and expenses incurred in the payment of claims by the member insurer if they are chargeable to the account for which the assessment is made.]

Comment: The maximum assessment per year may be varied from state to state depending on the size of the base. The figure used should produce sufficient funds to
handle any possible insolvency, keeping in mind that the total amount may not be needed in one year. The two percent maximum used here would have produced in 1968 on a nationwide basis, from the kinds of insurance to which this Act applies, approximately $500,000,000.

(4) Investigate claims brought against the Association and adjust, compromise, settle and pay covered claims to the extent of the Association’s obligation and deny all other claims and may review settlements, releases and judgments to which the insolvent insurer or its insureds were parties to determine the extent to which such settlements, releases and judgments may be properly contested.

(5) Notify such persons as the Commissioner directs under Section 10B(1).

Comment: The liquidation statutes of the state may describe the persons to be notified by the liquidator, but since this Association provides a distinctive service, the Commissioner may wish to require a separate notification by it.

(6) Handle claims through its employees or through one or more insurers or other persons designated as servicing facilities. Designation of a servicing facility is subject to the approval of the Commissioner, but the designation may be declined by a member insurer.

(7) Reimburse each servicing facility for obligations of the Association paid by the facility and for expenses incurred by the facility while handling claims on behalf of the Association and shall pay the other expenses of the Association authorized by this Act.

B. The Association may:

(1) Employ or retain such persons as are necessary to handle claims and perform other duties of the Association;

(2) Borrow funds necessary to effect the purposes of this Act in accordance with the plan of operation;

(3) Sue or be sued;

(4) Negotiate and become a party to such contracts as are necessary to carry out the purpose of this Act;

(5) Perform such other acts as are necessary or proper to effectuate the purpose of this Act;

(6) Refund to the member insurers in proportion to the contribution of each member insurer to the Association that amount by which the assets of the Association exceed the liabilities, if at the end of any calendar year, the board of directors finds that the assets of the Association exceed the liabilities of the Association as estimated by the board of directors for the coming year.

[Alternate Section 8B(6)]

(6) Refund to the member insurers in proportion to the contribution of each member insurer to that account that amount by which the assets of the account exceed the liabilities, if at the end of any calendar year, the board of directors finds that the assets of the Association in any account exceed the liabilities of that account as estimated by the board of directors for the coming year.]

Comment: The subcommittee feels that the board of directors should determine the amount of the refunds to members when the assets of the Association exceed its
liabilities. However, since this excess may be quite small, the board is given the option of retaining all or part of it to pay expenses and possibly remove the need for a relatively small assessment at a later time.

19. The 24 Hour Coverage Pilot Project Model Act provides the following discussion of guaranty fund assessments:

Section 15. Guaranty Fund Participation

The twenty-four hour medical insurance policy shall be classified as property and casualty coverage regardless of the carrier approved to provide the coverage. As such, the carrier shall be obligated to participate in the property and casualty guaranty association specified in [insert applicable section providing for participation in the property and casualty insurance guaranty association]. All premiums collected for the twenty-four hour medical insurance policy shall be considered assessable premiums for purposes of participation in the guaranty association. In the event of insolvency of the carrier, the guaranty association shall honor the full extent of the contractual obligation assumed by the carrier under the twenty-four hour medical insurance policy.

Section 16. Special Assessments

A carrier providing coverage to an employer through the twenty-four hour medical insurance policy is obligated to participate in the [insert reference to residual market mechanism, second injury fund or other fund that relies on assessments from workers compensation insurance premiums]. For purposes of calculation of this special assessment, the commissioner shall establish by rule, or order, the amount of premium generated under the twenty-four hour medical insurance policy which shall be considered assessable premium.

Drafting Note: A state should consider the ratio of the workers compensation standard premium to the total premium for both workers compensation and the health insurance plan used by the employer in choosing an appropriate amount. States with relatively small residual market shares for workers compensation may choose to exclude this section. States should consider loss based assessments, if applicable.

20. The Health Maintenance Organization Model Act contains the following:

Section 33. Insolvency Protection; Assessment

A. When a health maintenance organization in this state is declared insolvent by a court of competent jurisdiction, the [commissioner] may levy an assessment on health maintenance organizations doing business in this state to pay claims for uncovered expenditures for enrollees who are residents of this state and to provide continuation of coverage for subscribers or enrollees not covered under Section 15. The [commissioner] may not assess in any one calendar year more than two percent (2%) of the aggregate premium written by each health maintenance organization in this state the prior calendar year.

B. The [commissioner] may use funds obtained under Subsection A to pay claims for uncovered expenditures for subscribers or enrollees of an insolvent health maintenance organization who are residents of this state, provide for continuation of coverage for subscribers or enrollees who are residents of this state and are not covered under Section 15, and administrative costs. The [commissioner] may by regulation prescribe the time, manner and form for filing claims under this section or may require claims to be allowed by an ancillary receiver or the domestic liquidator or receiver.
C. (1) A receiver or liquidator of an insolvent health maintenance organization shall allow a claim in the proceeding in an amount equal to administrative and uncovered expenditures paid under this section.

(2) Any person receiving benefits under this section for uncovered expenditures is deemed to have assigned the rights under the covered health care plan certificates to the [commissioner] to the extent of the benefits received. The [commissioner] may require an assignment to it of such rights by any payee, enrollee, or beneficiary as a condition precedent to the receipt of any rights or benefits conferred by this section upon that person. The [commissioner] is subrogated to these rights against the assets of an insolvent health maintenance organization held by a receiver or liquidator of another jurisdiction.

(3) The assignment of subrogation rights of the [commissioner] and allowed claim under this subsection have the same priority against the assets of the insolvent health maintenance organization as those possessed by the person entitled to receive benefits under this section or for similar expenses in the receivership or liquidation.

D. When assessed funds are unused following the completion of the liquidation of a health maintenance organization, the [commissioner] will distribute on a pro rata basis any amounts received under Subsection A which are not de minimis to the health maintenance organizations that have been assessed under this section.

E. The aggregate coverage of uncovered expenditures under this section shall not exceed $300,000 with respect to one individual. Continuation of coverage shall not continue for more than the lesser of one year after the health maintenance organization coverage is terminated by insolvency or the remaining term of the contract. The [commissioner] may provide continuation of coverage on any reasonable basis; including, but not limited to, continuation of the health maintenance organization contract or substitution of indemnity coverage in a form determined by the [commissioner].

F. The [commissioner] may waive an assessment of a health maintenance organization if it would be or is impaired or placed in financially hazardous condition. A health maintenance organization which fails to pay an assessment within thirty (30) days after notice is subject to a civil forfeiture of not more than $1,000 per day and suspension or revocation of its certificate of authority. An action taken by the [commissioner] in enforcing the provisions of this section may be appealed by the health maintenance organization in accordance with [the administrative procedures act].

Drafting Comment: Section 33 is not recommended for all states. A state should carefully review its health maintenance organization market to determine whether the assessment procedure under this section is feasible. If health maintenance organization premium volume is small or dominated by a few organizations, a state may wish to rely solely on the protections provided under Section 14 and 15.

For those states where an assessment is feasible, this section provides assurance that funds will be available to pay uncovered expenditures even if those liabilities have been underestimated by the organization or have significantly escalated as the financial condition of the organization deteriorated. In addition, an assessment provides a means for continued coverage for those subscribers or enrollees who are not protected under Section 15.

Generally Accepted Accounting Principles
21. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies contains the following in Chapter 7, Capital and Surplus:

In lieu of capital stock, mutual companies are organized with prescribed minimum surplus which varies among states. Such surplus may take the form of guaranty funds, guaranty capital, or
other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

22. AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments contains the following guidance (only pertinent sections included):

**Reporting Liabilities**

10. Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met:

   a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.

   b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

   c. The amount of the assessment can be reasonably estimated.

**Probability of Assessment**

11. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to formal determination of insolvency. Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph 4), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the loss on which the assessments are expected to be based are incurred.

**Obligating Event**

12. Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may not be the event that obligates the entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment defined in this SOP.

13. For premium-based assessments, the event that obligates the entity is generally writing the premium or becoming obligated to write or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

14. For loss-based assessments, the event that obligates an entity is an entity’s incurring the losses on which the assessments are expected to be based.

The SOP defines the condition of obligation differently than the issue paper. This issue paper indicates that the conditions of probability and obligation have been satisfied when insolvency has occurred, regardless of whether the assessment is based upon premiums or losses written, incurred or paid before or after the insolvency. This issue paper rejects SOP 97-3 because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. This issue paper has incorporated language from the Ability to Reasonably Estimate the Liability section of the SOP in paragraph 7.
OTHER SOURCES OF INFORMATION

23. The draft discussion material from previous Property/Casualty codification projects provides the following guidance:

CHAPTER X
GUARANTEE FUND AND OTHER ASSESSMENTS

The expense for guarantee fund and other assessments should be reported as taxes, licenses and fees in the annual statement (and not as loss payments) when incurred. Specific assessment practices differ from state to state. In general, however, when an assessment is made, in addition to the amount requested, an estimate of the ultimate range of assessment may be indicated. Experience has shown that these ranges may change dramatically within a short time frame. The expense is incurred when an insolvency has occurred, an assessment is probable, and the amount can be reasonably estimated.

Accounting for Guarantee Fund and Other Assessments

Guarantee fund and other assessments are incurred, must be expensed, and a liability established when the following criteria are met:

a. An insolvency has occurred which creates an obligation for a state guarantee fund. This obligation will usually be evident when a company receives a court order for liquidation.

b. Information available indicates that it is probable that a liability has been incurred.

c. The amount of the liability can be reasonable estimated.

The amount accrued must reflect the ultimate liability expected from the insolvency. The accrual will be determined net of anticipated premium tax offsets.

If it is probable that a liability has been incurred from an insolvency, but it can not be reasonable estimate, a footnote should disclose the nature of the contingent liability and shall express the potential range of the anticipated loss exposure, when the potential liability is deemed material.

Reporting for Guarantee Fund and Other Assessments

The expense for guarantee fund and other assessments should be reported as taxes, licenses and fees in the annual statement (and not as loss payments) when incurred.

Assessment for which the Insurance company acts as Agent for the State

In certain circumstances, an insurance company acts as an agent for certain state agencies in the collection and remittance of fees or assessments. In these circumstances, the liability for the fees and assessments rests with the policyholder rather than with the insurance company. The insurance company's obligation is to collect and subsequently remit the fee or assessment. These situations differ from a premium tax liability whereby the insurance company is required to remit the premium tax whether or not the premium has been collected.

When both the following conditions are met, an assessment should not be reported in the statement of operations of an insurance company:

- The assessment is reflected as a separately identifiable item on the billing to the policyholder; and
Remittance of the assessment by the insurance company to the state is contingent upon collection from the insured.

24. NAIC Technical Resource Group Proposed Draft Life Codification provides the following guidance in Chapter 22, General Expenses and Taxes, Licenses and Fees:

6. All other taxes will include guaranty fund assessments and taxes of Canada or of any other foreign country not specifically provided for elsewhere. Guaranty fund and other assessments must be expended and a liability established when the following criteria are met:

- An insolvency has occurred which creates an obligation for a state guaranty fund; this obligation will usually be evident when a company receives a court order for liquidation;

- Information available indicates it is probable that a liability has been incurred; and

- The amount of the loss can be reasonably estimated using the risk free investment rate of a bond having a duration equivalent to the duration of the liability.

The amount accrued must reflect the ultimate loss exposure expected from the insolvency. The accrual will be determined net of estimated premium tax offsets and will reflect the present value of the anticipated payments.

If it is probable a liability has been incurred from an insolvency, but it cannot be reasonably estimated, the nature of the contingent liability and the potential range of the anticipated loss exposure must be disclosed in the notes to the financial statements, when the potential liability is deemed material.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies, and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus
- NAIC Annual Statement Instructions
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force, 92-1, Minutes, Meeting of February 21, 1992
- Life and Health Insurance Guaranty Association Model Act, Section 9 - Assessments
- Post-Assessment Property & Liability Insurance Guaranty Association Model Act, Section 8 - Assessments
- 24 Hour Coverage Pilot Project Model Act, Sections 15 and 16
- Health Maintenance Organization Model Act, Section 33
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies, Chapter 7, Capital and Surplus, section 7.03
- AICPA Statement of Position 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments
State Regulations
- No further guidance obtained from state statutes or regulations.

Other Sources of Information
- Draft discussion material from previous Property/Casualty Codification Projects, Chapter X, Guarantee Fund and Other Assessments
Statutory Issue Paper No. 36

Troubled Debt Restructurings

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A troubled debt restructuring exists when a creditor, for economic or legal reasons related to the debtor’s financial difficulties, grants a concession to the debtor that it would not otherwise grant. A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:
   a. Transfer of assets to the creditor by the debtor, including a transfer resulting from foreclosure or repossession.
   b. Transfer of an equity interest in the debtor to the creditor.
   c. Modification of the terms of the debt, such as a reduction in the principal amount, interest rate or an extension of payment due dates.

Current statutory guidance on troubled debt restructurings is limited to guidance on accounting for loans that are in the process of foreclosure and real estate obtained through foreclosure.

2. GAAP guidance has established more comprehensive accounting principles in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings (FAS 15), as amended by FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), and FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures (FAS 118).

3. The purpose of this issue paper is to establish statutory accounting principles for troubled debt restructurings that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definition of Troubled Debt Restructuring

4. A troubled debt restructuring shall be defined as a debt restructuring whereby the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise grant. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructurings involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. The creditor, for example, may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment. A troubled debt restructuring shall include debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the
debtor that is, in a technical sense, not restructured. The determination of whether a debt restructuring is considered a troubled debt restructuring, as defined above, shall be made independently for the debtor and the creditor.

5. A debt restructuring shall not necessarily be considered a troubled debt restructuring for purposes of this issue paper even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if

a. the fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;

b. the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable;

c. the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate;

d. the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors; or

e. the debtor, in connection with bankruptcy proceedings, enters into debt restructuring that results in a general restatement of most of the debtor's liabilities.

In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

Accounting by Debtors
6. A debtor shall account for a troubled debt restructuring according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms or combination of types). Generally, troubled debt restructurings involving the transfer of assets or the grant of an equity interest shall be accounted for at the fair value of the assets transferred or the equity interest granted, as outlined in paragraph 20 of this issue paper. Troubled debt restructurings involving a modification of terms shall be accounted for prospectively, as outlined in paragraph 20 of this issue paper.

Accounting by Creditors
7. A creditor shall account for a troubled debt restructuring according to the type of the restructuring (receipt of assets in full satisfaction, modification of terms, combination of types). Generally, troubled debt restructurings involving the transfer of assets shall be accounted for at the fair value of the assets received, as outlined in paragraph 20 of this issue paper. Troubled debt restructurings involving modification of terms shall be accounted for at fair value (as determined by acceptable appraisal methodologies or, if applicable, the value determined in accordance with the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures)). If the restructured loan is collateral dependent, fair value shall be the fair value of the collateral. If the restructured loan is not collateral dependent, fair value shall be determined in accordance with the SVO Purposes and Procedures, if applicable, or at the present value of expected future cash
flows, as discussed in paragraph 21 of this issue paper. If the determined fair value of the loan is less than
the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and
unamortized premium or discount), a new cost basis shall be established at the fair value with the
difference being recorded as a realized loss in the statement of operations.

8. A creditor shall account for assets, including foreclosed property and equity interests in
corporations, joint ventures, or partnerships, received in satisfaction of the loan at their fair value (as
determined by acceptable appraisal methodologies or, if applicable, the value determined in accordance
with the SVO Purposes and Procedures) at the time of restructuring or at the book value of the loan if
lower. If the fair value is less than the book value, the required writedown shall be recognized as a
realized capital loss. The creditor shall reclassify the asset from loans to the appropriate asset account,
such as real estate or other invested assets, at the time that the creditor obtains clear title to the asset
except for mortgage loans which shall be reclassified at the beginning of the redemption period unless it
is probable that the mortgage loan will be redeemed. After the troubled debt restructuring, a creditor shall
account for the assets received in satisfaction of the loan consistent with the statutory guidance for similar
assets.

9. A creditor shall account for a modification of terms in accordance with paragraphs 20 and 21 of
this issue paper. Any fees received in connection with a modification of terms of a troubled debt
restructuring shall be applied as a reduction of the recorded investment in the loan. All costs associated
with the restructuring, including direct loan origination costs, shall be charged to expense as incurred.

Disclosure
10. A debtor in a troubled debt restructuring shall follow the disclosure requirements described in
paragraph 20 of this issue paper. A creditor in a troubled debt restructuring shall follow the disclosure
requirements described in paragraph 22 of this issue paper except the requirement to record the activity in
an allowance account, which is required in Issue Paper No. 37, Mortgage Loans.

DISCUSSION
11. This issue paper adopts FAS 15 with modification to specify that creditors shall reclassify assets
obtained in a troubled debt restructuring from loans to the appropriate asset account at the time the
creditor obtains clear title to the asset except for mortgage loans which shall be reclassified at the
beginning of the redemption period unless it is probable that the mortgage loan will be redeemed (see
paragraph 15 below for justification). It also adopts paragraphs 9, 22 and 25 of FAS 114 which require
creditors to measure all loans that are restructured in a troubled debt restructuring involving a
modification of terms in accordance with FAS 114. FAS 114 requires that impaired loans be measured
based on the present value of expected future cash flows discounted at the loan's effective interest rate or,
as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan
is collateral dependent. The values determined in accordance with the SVO Purposes and Procedures are
used as a loan's observable market price or fair value. It also adopts FAS 118 (i.e., when the provisions of
FAS 114 are applied in accounting for a troubled debt restructuring that involves a modification of terms,
the provisions of FAS 118 apply). FAS 118 amends certain income recognition provisions previously
required by FAS 114 as well as exempts troubled debt restructurings accounted for under FAS 114 from
certain disclosure requirements. It also adopts FASB Technical Bulletin 81-6, Applicability of Statement
15 to Debtors in Bankruptcy Situations (FTB 81-6), which states that FAS 15 does not apply to debtors
who, in connection with bankruptcy proceedings, enter into a troubled debt restructuring that results in a
general restatement of the debtor's liabilities. It also adopts FASB Technical Bulletin 80-2, Classification
of Debt Restructuring by Debtors and Creditors (FTB 80-2), which states that a debtor may have a
troubled debt restructuring under FAS 15 even though the related creditor does not. FASB Emerging
Issue Task Force Issue No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring (EITF
87-18), FASB Emerging Issue Task Force Issue No. 87-19, Substituted Debtors in a Troubled Debt

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Restructuring (EITF 87-19), and FASB Emerging Issue Task Force Issue No. 89-15, Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties (EITF 89-15), provide guidance on the application of FAS 15 and are adopted in this issue paper consistent with the modifications to FAS 15 discussed in this issue paper. This issue paper also adopts FASB Emerging Issue Task Force Issue No. 96-22, Applicability of the Disclosures Required by FASB Statement No. 114 When a Loan Is Restructured in a Troubled Debt Restructuring into Two (or More) Loans.

12. This issue paper is consistent with paragraph 14 of FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loan and Initial Direct Costs of Leases (FAS 91), which requires that fees received in connection with a modification of terms of a troubled debt restructuring be applied as a reduction of the recorded investment in the loan and that all related costs be charged to expense as incurred. FAS 91 was rejected in Issue Paper Nos. 26, 37, and 43.

13. This issue paper rejects the GAAP guidance set forth in FASB Emerging Issues Task Force Issue No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring (EITF 94-8), which states that FASB Statement No. 115, Accounting for Certain Investment in Debt and Equity Securities (FAS 115), applies to securities received in connection with a loan restructuring. It also rejects the GAAP guidance set forth in FASB Technical Bulletin 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring (FTB 94-1), which states that FAS 115 applies to any loan that was restructured in a troubled debt restructuring involving a modification of terms that meets the definition of a security (as defined in FAS 115). It also rejects paragraph 6 (d) of FAS 114 by requiring that the requirements of FAS 114 be applied to debt securities. This is consistent with the rejection of FAS 115 in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities, Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies) and Issue Paper No. 32 - Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies). Paragraph 13 of FAS 114 which requires impairment to be recognized through a valuation allowance is rejected. Paragraph 7 of this issue paper requires the difference between the fair value and the recorded value to be recorded as a realized loss in the statement of operations which is consistent with the rejection of the utilization of valuation allowances in statutory accounting. This issue paper requires assets to be recorded at the lower of fair value or book value. Practically speaking, this is no different from the FAS 114 requirement to record at fair value. In a troubled debt restructuring situation, it will be unusual for the fair value to exceed the book value.


15. Current statutory guidance does not specifically address accounting and disclosure by debtors and creditors for troubled debt restructuring. The SVO Purposes and Procedures provides a designation for “Bonds and Counterparties In or Near Default”. The accounting for such bonds is addressed in Issue Paper No. 26 which requires that such bonds be written down to fair market value, is consistent with this issue paper. The statutory literature also provides guidance on the reclassification of foreclosed mortgage loans to real estate. The guidance states that loans for which foreclosure proceedings have been completed, and where there are debtor redemption privileges, may temporarily retain their status as mortgage loans until the insurance company obtains clear title. This issue paper rejects this concept and allows the creditor to reclassify the asset at the beginning of the redemption period unless it is probable that the mortgage loan will be redeemed. This revision to current statutory accounting is justified because the nature of the asset has effectively changed when the foreclosure process has been substantially completed. This is also consistent with current industry practice.
16. The adoption of the statutory accounting principles specified in the conclusion above are consistent with the Statement of Concepts which states "In order to provide a margin of protection for policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting" and "Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency".

Drafting Notes/Comments
- Accounting for mortgage loan impairments is addressed in Issue Paper No. 37 - Mortgage Loans.
- Accounting for real estate is addressed in Issue Paper No. 40 - Real Estate Investments.
- Accounting for collateral dependent loans is addressed in Issue Paper No. 37 - Mortgage Loans.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) each include the following in Chapter 3, Mortgage Loans (only the pertinent excerpts are included below):

Valuation

For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value may be adjusted for unpaid interest and additional expenses, such as insurance, taxes and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that such amounts are deemed to be recoverable from the ultimate disposition of the property. However, if such interest and costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and the cost should be expensed.

If, when reporting mortgage loans in default, the values of real estate have declined to less than the unpaid principal balances, an appropriate valuation reserve should be established to reflect the expected uncollectible amount.

Mortgage loans that are in default, or which are under foreclosure proceedings, continue to be classified as mortgage loans. Loans for which foreclosure proceedings have been completed, even to the extent of the court granting title to the mortgages, may temporarily retain their status as mortgage loans, since in some states the mortgagor still has the privilege of redeeming the mortgage during a stated redemption period. During this period, the loan may remain classified as a mortgage loan until the insurance company obtains clear title. The asset is then transferred to the real estate account.

18. The Life/A&H Accounting Practices and Procedures Manual includes the following in Chapter 4, Real Estate (only the pertinent excerpts are included below):

Cost

The cost of real estate acquired through foreclosure or voluntary conveyance is recorded at the lower of fair market value at acquisition or cost. Cost includes the outstanding principal balance of the mortgage loan at the date of foreclosure or conveyance plus foreclosure costs, real estate taxes, insurance premiums and all other costs necessary to obtain clear title and to place the property in good repair. Uncollected interest or unrecovered advances made before foreclosure should also be included in cost.
Statement Value

Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost, plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

19. The P & C Accounting Practices and Procedures Manual includes the following in Chapter 4, Real Estate (only the pertinent excerpts are included below):

Cost

The cost of real estate acquired through foreclosure generally includes the outstanding principal balance of the mortgage loan at the date of foreclosure, plus foreclosure costs, real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and to place the property in good repair. Unrecovered advances made before foreclosure should also be included in cost. The total cost should not exceed the realizable value.

Statement Value

Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost, plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

Generally Accepted Accounting Principles

20. FAS 15 provides the following definition and guidance for troubled debt restructuring:

INTRODUCTION

2. A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court. For example, a creditor may restructure the terms of a debt to alleviate the burden of the debtor's near-term cash requirements, and many troubled debt restructuring involve modifying terms to reduce or defer cash payments required of the debtor in the near future to help the debtor attempt to improve its financial condition and eventually be able to pay the creditor. Or, for example, the creditor may accept cash, other assets, or an equity interest in the debtor in satisfaction of the debt though the value received is less than the amount of the debt because the creditor concludes that step will maximize recovery of its investment.1

1 Although troubled debt that is fully satisfied by foreclosure, repossession, or other transfer of assets or by grant of equity securities by the debtor is, in a technical sense, not restructured, that kind of event is included in the term troubled debt restructuring in this Statement.

3. Whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it.
4. In this Statement, a receivable or payable (collectively referred to as debt) represents a contractual right to receive money or a contractual obligation to pay money on demand or on fixed or determinable dates that is already included as an asset or liability in the creditor's or debtor's balance sheet at the time of the restructuring. Receivables or payables that may be involved in troubled debt restructuring commonly result from lending or borrowing of cash, investing in debt securities that were previously issued, or selling or purchasing goods or services on credit. Examples are accounts receivable or payable, notes, debentures and bonds (whether those receivables or payables are secured or unsecured and whether they are convertible or nonconvertible), and related accrued interest, if any. Typically, each receivable or payable is negotiated separately, but sometimes two or more receivables or payables are negotiated together. For example, a debtor may negotiate with a group of creditors but sign separate debt instruments with each creditor. For purposes of this Statement, restructuring of each receivable or payable, including those negotiated and restructured jointly, shall be accounted for individually. The substance rather than the form of the receivable or payable shall govern. For example, to a debtor, a bond constitutes one payable even though there are many bondholders.

5. A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

a. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession).

b. Issuance or other granting of an equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.

c. Modification of terms of a debt, such as one or a combination of:

1. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt.

2. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.

3. Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.

4. Reduction (absolute or contingent) of accrued interest.

6. Troubled debt restructuring may occur before, at, or after the stated maturity of debt, and time may elapse between the agreement, court order, etc. and the transfer of assets or equity interest, the effective date of new terms, or the occurrence of another event that constitutes consummation of the restructuring. The date of consummation is the time of the restructuring in this Statement.

7. A debt restructuring is not necessarily a troubled debt restructuring for purposes of this Statement even if the debtor is experiencing some financial difficulties. For example, a troubled debt restructuring is not involved if (a) the fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable; (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at
the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. In general, a debtor that can obtain funds from sources other than the existing creditor at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring. A debtor in a troubled debt restructuring can obtain funds from sources other than the existing creditor in the troubled debt restructuring, if at all, only at effective interest rates (based on market prices) so high that it cannot afford to pay them. Thus, in an attempt to protect as much of its investment as possible, the creditor in a troubled debt restructuring grants a concession to the debtor that it would not otherwise consider.

2 Defined in paragraph 13.

3 Defined in footnote 17.

8. For purposes of this Statement, troubled debt restructurings do not include changes in lease agreements (the accounting is prescribed by FASB Statement No. 13, “Accounting for Leases”) or employment-related agreements (for example, pension plans and deferred compensation contracts). Nor do troubled debt restructuring include debtors' failures to pay trade accounts according to their terms or creditors' delays in taking legal action to collect overdue amounts of interest and principal, unless they involve an agreement between debtor and creditor to restructure.

(Note: Paragraph 9 not included as deleted or superseded)

10. This Statement supersedes FASB Interpretation No. 2, “Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act,” and shall be applied to the types of situations that were covered by that Interpretation. Thus, it shall be applied to troubled debt restructuring consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other Federal statutes related thereto.4 It also amends APB Opinion No. 26, “Early Extinguishment of Debt,” to the extent needed to exclude from that Opinion's scope early extinguishments of debt through troubled debt restructuring.

4 This Statement does not apply, however, if under provisions of those Federal statutes or in a quasi-reorganization or corporate readjustment (ARB No. 43, Chapter 7, Section A, “Quasi-Reorganization or Corporate Readjustment...”) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting by Debtors

12. A debtor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs.

Transfer of Assets in Full Settlement

13. A debtor that transfers its receivables from third parties, real estate, or other assets to a creditor to settle fully a payable shall recognize a gain on restructuring of payables (see paragraph 21). The gain shall be measured by the excess of (i) the carrying amount of the payable settled (the face amount increased or decreased by applicable accrued interest and
applicable unamortized premium, discount, finance charges, or issue costs) over (ii) the fair value of the assets transferred to the creditor.\(^5\) The fair value of the assets transferred is the amount that the debtor could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.\(^6\)

\(^5\) Paragraphs 13, 15, and 19 indicate that the fair value of assets transferred or the fair value of an equity interest granted shall be used in accounting for a settlement of a payable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the payable settled if more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable (paragraphs 13 and 15). (See paragraph 67 of APB Opinion No. 16, “Business Combinations.”) However, in a partial settlement of a payable (paragraph 19), the fair value of the assets transferred or of the equity interest granted shall be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

\(^6\) Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB Opinion No. 16, paragraphs 12-14 of APB Opinion No. 21, “Interest on Receivables and Payables,” and paragraph 25 of APB Opinion No. 29, “Accounting for Nonmonetary Transactions.”

14. A difference between the fair value and the carrying amount of assets transferred to a creditor to settle a payable is a gain or loss on transfer of assets.\(^7\) The debtor shall include that gain or loss in measuring net income for the period of transfer, reported as provided in APB Opinion No. 30, “Reporting the Results of Operations.”

\(^7\) The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other “valuation” accounts, if any. A loss on transferring receivables to creditors may therefore have been wholly or partially recognized in measuring net income before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss in measuring net income for the period of the transfer.

Grant of Equity Interest in Full Settlement

15. A debtor that issues or otherwise grants an equity interest to a creditor to settle fully a payable shall account for the equity interest at its fair value.\(^8\) The difference between the fair value of the equity interest granted and the carrying amount of the payable settled shall be recognized as a gain on restructuring of payables (see paragraph 21).

\(^8\) See footnote 5.

Modification of Terms

16. A debtor in a troubled debt restructuring involving only modification of terms of a payable—that is, not involving a transfer of assets or grant of an equity interest—shall account for the
effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms.\(^9\) That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods.\(^10\) Interest expense shall be computed in a way that a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity (in substance the “interest” method prescribed by paragraph 15 of APB Opinion No. 21). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

\(^9\) In this Statement, total future cash payments includes related accrued interest, if any, at the time of the restructuring that continues to be payable under the new terms.

\(^10\) All or a portion of the carrying amount of the payable at the time of the restructuring may need to be reclassified in the balance sheet because of changes in the terms, for example, a change in the amount of the payable due within one year after the date of the debtor's balance sheet. A troubled debt restructuring of a short-term obligation after the date of a debtor's balance sheet but before that balance sheet is issued may affect the classification of that obligation in accordance with FASB Statement No. 6, "Classification of Short-Term Obligations Expected to Be Refinanced."

17. If, however, the total future cash payments specified by the new terms of a payable, including both payments designated as interest and those designated as face amount, are less than the carrying amount of the payable, the debtor shall reduce the carrying amount to an amount equal to the total future cash payments specified by the new terms and shall recognize a gain on restructuring of payables equal to the amount of the reduction (see paragraph 21).\(^11\) Thereafter, all cash payments under the terms of the payable shall be accounted for as reductions of the carrying amount of the payable, and no interest expense shall be recognized on the payable for any period between the restructuring and maturity of the payable.\(^12\)

\(^11\) If the carrying amount of the payable comprises several accounts (for example, face amount, accrued interest, and unamortized premium, discount, finance charges, and issue costs) that are to be continued after the restructuring, some possibly being combined, the reduction in carrying amount may need to be allocated among the remaining accounts in proportion to the previous balances. However, the debtor may choose to carry the amount designated as face amount by the new terms in a separate account and adjust another account accordingly.

\(^12\) The only exception is to recognize interest expense according to paragraph 22.

18. A debtor shall not recognize a gain on a restructured payable involving indeterminate future cash payments as long as the maximum total future cash payments may exceed the carrying amount of the payable. Amounts designated either as interest or as face amount by the new terms may be payable contingent on a specified event or circumstance (for example, the debtor may be required to pay specified amounts if its financial condition improves to a specified degree within a specified period). To determine whether the debtor shall recognize a gain according to the provisions of paragraphs 16 and 17, those contingent amounts shall be included in the "total future cash payments specified by the new terms" to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. Thus, the debtor shall apply paragraph 17 of FASB Statement No. 5, "Accounting for Contingencies," in which probability of occurrence of a gain contingency is not a factor, and shall assume that
contingent future payments will have to be paid. The same principle applies to amounts of future cash payments that must sometimes be estimated to apply the provisions of paragraphs 16 and 17. For example, if the number of future interest payments is flexible because the face amount and accrued interest is payable on demand or becomes payable on demand, estimates of total future cash payments shall be based on the maximum number of periods possible under the restructured terms.

Combination of Types

19. A troubled debt restructuring may involve partial settlement of a payable by the debtor's transferring assets or granting an equity interest (or both) to the creditor and modification of terms of the remaining payable. A debtor shall account for a troubled debt restructuring involving a partial settlement and a modification of terms as prescribed in paragraphs 16-18 except that, first, assets transferred or an equity interest granted in that partial settlement shall be measured as prescribed in paragraphs 13 and 15, respectively, and the carrying amount of the payable shall be reduced by the total fair value of those assets or equity interest. A difference between the fair value and the carrying amount of assets transferred to the creditor shall be recognized as a gain or loss on transfer of assets. No gain on restructuring of payables shall be recognized unless the remaining carrying amount of the payable exceeds the total future cash payments (including amounts contingently payable) specified by the terms of the debt remaining unsettled after the restructuring. Future interest expense, if any, shall be determined according to the provisions of paragraphs 16-18.

13 Even if the stated terms of the remaining payable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the transfer of assets or grant of an equity interest, the restructuring shall be accounted for as prescribed by paragraph 19.

14 If cash is paid in a partial settlement of a payable in a troubled debt restructuring, the carrying amount of the payable shall be reduced by the amount of cash paid.

Related Matters

20. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor or other transfer of assets to the creditor shall be accounted for according to the provisions of paragraphs 13, 14, and 19.

21. Gains on restructuring of payables determined by applying the provisions of paragraphs 13-20 of this Statement shall be aggregated, included in measuring net income for the period of restructuring, and, if material, classified as an extraordinary item, net of related income tax effect, in accordance with paragraph 8 of FASB Statement No. 4, “Reporting Gains and Losses from Extinguishment of Debt.”

22. If a troubled debt restructuring involves amounts contingently payable, those contingent amounts shall be recognized as a payable and as interest expense in future periods in accordance with paragraph 8 of FASB Statement No. 5. Thus, in general, interest expense for contingent payments shall be recognized in each period in which (a) it is probable that a liability has been incurred and (b) the amount of that liability can be reasonably estimated. Before recognizing a payable and interest expense for amounts contingently payable, however, accrual or payment of those amounts shall be deducted from the carrying amount of the restructured payable to the extent that contingent payments included in “total future cash payments specified by the new terms” prevented recognition of a gain at the time of restructuring (paragraph 18).

23. If amounts of future cash payments must be estimated to apply the provisions of paragraphs 16-18 because future interest payments are expected to fluctuate—for example,
restructured terms may specify the stated interest rate to be the prime interest rate increased by a specified amount or proportion—estimates of maximum total future payments shall be based on the interest rate in effect at the time of the restructuring. Fluctuations in the effective interest rate after the restructuring from changes in the prime rate or other causes shall be accounted for as changes in estimates in the periods the changes occur. However, the accounting for those fluctuations shall not result in recognizing a gain on restructuring that may be offset by future cash payments (paragraphs 18 and 22). Rather, the carrying amount of the restructured payable shall remain unchanged, and future cash payments shall reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments.

24. Legal fees and other direct costs that a debtor incurs in granting an equity interest to a creditor in a troubled debt restructuring shall reduce the amount otherwise recorded for that equity interest according to paragraphs 15 and 19. All other direct costs that a debtor incurs to effect a troubled debt restructuring shall be deducted in measuring gain on restructuring of payables or shall be included in expense for the period if no gain on restructuring is recognized.

Disclosure by Debtors

25. A debtor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructurings that have occurred during a period for which financial statements are presented:

   a. For each restructuring: 15 a description of the principal changes in terms, the major features of settlement, or both.

   __________

   15 Separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debentures) may be grouped for disclosure purposes.

   __________

   b. Aggregate gain on restructuring of payables and the related income tax effect (paragraph 21).

   c. Aggregate net gain or loss on transfers of assets recognized during the period (paragraphs 14 and 19).

   d. Per share amount of the aggregate gain on restructuring of payables, net of related income tax effect.

26. A debtor shall disclose in financial statements for periods after a troubled debt restructuring the extent to which amounts contingently payable are included in the carrying amount of restructured payables pursuant to the provisions of paragraph 18. If required by paragraphs 9-13 of FASB Statement No. 5, a debtor shall also disclose in those financial statements total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

Accounting by Creditors

27. A creditor shall account for a troubled debt restructuring according to the type of the restructuring as prescribed in the following paragraphs. Paragraphs 28-42 do not apply to a receivable that the creditor is accounting for at market value in accordance with the specialized industry practice (for example, a marketable debt security accounted for at market value by a mutual fund). Estimated cash expected to be received less estimated costs expected to be incurred is not market value in accordance with specialized industry practice as that term is used in this paragraph.
Receipt of Assets in Full Satisfaction

28. A creditor that receives from a debtor in full satisfaction of a receivable either (i) receivables from third parties, real estate, or other assets or (ii) shares of stock or other evidence of an equity interest in the debtor, or both, shall account for those assets (including an equity interest) at their fair value at the time of the restructuring (see paragraph 13 for how to measure fair value). The excess of (i) the recorded investment in the receivable satisfied over (ii) the fair value of assets received is a loss to be recognized according to paragraph 35.

16 Paragraphs 28 and 33 indicate that the fair value of assets received shall be used in accounting for satisfaction of a receivable in a troubled debt restructuring. That guidance is not intended to preclude using the fair value of the receivable satisfied if more clearly evident than the fair value of the assets received in full satisfaction of a receivable (paragraph 28). (See paragraph 67 of APB Opinion No. 16.) However, in a partial satisfaction of a receivable (paragraph 33), the fair value of the assets received shall be used in all cases to avoid the need to allocate the fair value of the receivable between the part satisfied and the part still outstanding.

17 Recorded investment in the receivable is used in paragraphs 28-41 instead of carrying amount of the receivable because the latter is net of an allowance for estimated uncollectible amounts or other “valuation” account, if any, while the former is not. The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

29. After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.

Modification of Terms

(Note: Paragraphs 30-32 not included as superseded by FAS 114)

Combination of Types

33. A troubled debt restructuring may involve receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable. A creditor shall account for a troubled debt restructuring involving a partial satisfaction and modification of terms as prescribed in paragraphs 30-32 (note: paragraphs 30-32 superseded by FAS 114) except that, first, the assets received shall be accounted for at their fair values as prescribed in paragraph 28 and the recorded investment in the receivable shall be reduced by the fair value of the assets received.

22 Even if the stated terms of the remaining receivable, for example, the stated interest rate and the maturity date or dates, are not changed in connection with the receipt of assets (including an equity interest in the debtor), the restructuring shall be accounted for as prescribed by paragraph 33.

23 If cash is received in a partial satisfaction of a receivable, the recorded investment in the receivable shall be reduced by the amount of cash received.

Related Matters
34. A troubled debt restructuring that is in substance a repossession or foreclosure by the creditor, or in which the creditor otherwise obtains one or more of the debtor's assets in place of all or part of the receivable, shall be accounted for according to the provisions of paragraphs 28 and 33 and, if appropriate, 39.

(Note: Paragraphs 35-37 not included as superseded by FAS 114)

38. Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring shall be included in expense when incurred.

39. A receivable from the sale of assets previously obtained in a troubled debt restructuring shall be accounted for according to APB Opinion No. 21 regardless of whether the assets were obtained in satisfaction (full or partial) of a receivable to which that Opinion was not intended to apply. A difference, if any, between the amount of the new receivable and the carrying amount of the assets sold is a gain or loss on sale of assets.

Disclosure by Creditors

40. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about troubled debt restructuring as of the date of each balance sheet presented:

   a. (Note: not included as superseded by FAS 114)

   b. The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructuring.

(Note: Paragraph 41 not included as superseded by FAS 114)

Substitution or Addition of Debtors

42. A troubled debt restructuring may involve substituting debt of another business enterprise, individual, or government unit\textsuperscript{26} for that of the troubled debtor or adding another debtor (for example, as a joint debtor). That kind of restructuring should be accounted for according to its substance. For example, a restructuring in which, after the restructuring, the substitute or additional debtor controls, is controlled by, or is under common control\textsuperscript{27} with the original debtor is an example of one that shall be accounted for by the creditor according to the provisions of paragraphs 30-32 (note: paragraphs 30-32 superseded by FAS 114). Those paragraphs shall also apply to a restructuring in which the substitute or additional debtor and original debtor are related after the restructuring by an agency, trust, or other relationship that in substance earmarks certain of the original debtor's funds or funds flows for the creditor although payments to the creditor may be made by the substitute or additional debtor. In contrast, a restructuring in which the substitute or additional debtor and the original debtor do not have any of the relationships described above after the restructuring shall be accounted for by the creditor according to the provisions of paragraphs 28 and 33.

\textsuperscript{26} Government units include, but are not limited to, states, counties, townships, municipalities, school districts, authorities, and commissions.

\textsuperscript{27} “Control” in this paragraph has the meaning described in paragraph 3 (c) of APB Opinion No. 18, “The Equity Method of Accounting for Investments in Common Stock”: “The usual condition for control is ownership of a majority (over 50\%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree.”
21. FAS 114 modified certain provisions of FAS 15 to require creditors to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with FAS 114 which requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. FAS 114 provides the following guidance:

Definitions and Scope

4. For purposes of this Statement, a loan is a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.

5. This Statement applies to all creditors. It addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined. This Statement also addresses the accounting by creditors for all loans that are restructured in a troubled debt restructuring involving a modification of terms of a receivable, except restructuring of loans excluded from the scope of this Statement in paragraph 6(b)-(d), including those involving a receipt of assets in partial satisfaction of a receivable. The term troubled debt restructuring is used in this Statement consistent with its use in Statement 15.

6. This Statement applies to all loans that are identified for evaluation, uncollateralized as well as collateralized, except:

   a. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans.

   b. Loans that are measured at fair value or at the lower of cost or fair value, for example, in accordance with FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, or other specialized industry practice.

   c. Leases as defined in FASB Statement No. 13, Accounting for Leases.

   d. Debt securities as defined in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

7. This Statement does not specify how a creditor should identify loans that are to be evaluated for collectibility. A creditor should apply its normal loan review procedures in making that judgment. This Statement does not address when a creditor should record a direct write-down of an impaired loan, nor does it address how a creditor should assess the overall adequacy of the allowance for credit losses. In addition to the allowance calculated in accordance with this Statement, a creditor should continue to recognize an allowance for credit losses necessary to comply with Statement 5.

1 Sources of information useful in identifying loans for evaluation that are listed in the AICPA's Auditing Procedure Study, Auditing the Allowance for Credit Losses of Banks, include a specific materiality criterion; regulatory reports of examination; internally generated listings such as "watch lists," past due reports, overdraft listings, and listings of loans to insiders; management reports of total loan amounts by borrower; historical loss experience by type of loan; loan files lacking current financial data related to borrowers and guarantors;
borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions; loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value; loans to borrowers in industries or countries experiencing economic instability; and loan documentation and compliance exception reports.

Recognition of Impairment

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, as amended, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of this Statement. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.

9. Usually, a loan whose terms are modified in a troubled debt restructuring already will have been identified as impaired because the condition specified in paragraph 8 will have existed before a formal restructuring. However, if a loan is excluded from the scope of this Statement under paragraph 6(a), a creditor may not have accounted for that loan in accordance with this Statement before the loan was restructured. The creditor shall apply the provisions of this Statement to that loan when it is restructured.

10. The term probable is used in this Statement consistent with its use in Statement 5, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:

    Probable. The future event or events are likely to occur.

    Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

    Remote. The chance of the future event or events occurring is slight.

The term probable is further described in paragraph 84 of Statement 5, which states:

The conditions for accrual in paragraph 8 [of Statement 5] are not inconsistent with the accounting concept of conservatism. Those conditions are not intended to be so rigid that they require virtual certainty before a loss is accrued. They require only that it be probable that an asset has been impaired or a liability has been incurred and that the amount of loss be reasonably estimable.

Measurement of Impairment

11. Measuring impaired loans requires judgment and estimates, and the eventual outcomes may differ from those estimates. Creditors should have latitude to develop measurement methods that are practical in their circumstances. Paragraphs 12-16 address those measurement methods.
12. Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor will apply the measurement methods described in paragraphs 13-16 on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring those impaired loans.

13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the measure of the impaired loan is less than the recorded investment in the loan\(^2\) (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

\[^2\] The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

14. If a creditor measures an impaired loan using a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan).\(^3\) The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. If the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8. The creditor's choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

\[^3\] A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan.
15. If a creditor measures an impaired loan using a present value calculation, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a creditor estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

16. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

(Note: Paragraphs 17-19 are not included as they are superseded or deleted by FAS 118)

Disclosures

20. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information:

   a. As of the date of each statement of financial position presented, the recorded investment in the loans for which impairment has been recognized in accordance with this Statement and the total allowance for credit losses related to those impaired loans

   b. For each period for which results of operations are presented, the activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off

   c. The creditor's income recognition policy (paragraph 17(a) or (b)). A creditor that recognizes income in accordance with paragraph 17(a) also shall disclose the amount of interest income recognized in accordance with that paragraph.

Amendments to Existing Pronouncements

21. The first sentence of paragraph 23 of Statement 5 is replaced by the following:

   If, based on current information and events, it is probable that the enterprise will be unable to collect all amounts due according to the contractual terms of the receivable, the condition in paragraph 8(a) is met. As used here, all amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments will be collected as scheduled according to the receivable's contractual terms. However, a creditor need not consider an insignificant delay or insignificant shortfall in amount of payments as meeting the condition in paragraph 8(a).

22. Statement 15 is amended prospectively as follows:
a. The second sentence in paragraph 1 is replaced by:

A creditor in a troubled debt restructuring involving a modification of terms shall account for the restructured loan in accordance with the provisions of FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, except that a troubled debt restructuring involving a modification of terms before the effective date of Statement 114 may continue to be accounted for and disclosed in accordance with this Statement as long as the restructured loan is not impaired based on the terms of the restructuring agreement.

b. Paragraph 30 is replaced by the following:

A creditor in a troubled debt restructuring involving only a modification of terms of a receivable -- that is, not involving receipt of assets (including an equity interest in the debtor) -- shall account for the troubled debt restructuring in accordance with the provisions of Statement 114.

c. In the second sentence of paragraph 33, paragraphs 30-32 is deleted and replaced by Statement 114. The third and fourth sentences are deleted.

d. In paragraph 34, the following is added after "foreclosure by the creditor:"; that is, the creditor receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place,

e. In the third sentence of paragraph 42, according to the provisions of paragraphs 30-32 is replaced by as prescribed in Statement 114. In the fourth sentence, those paragraphs are replaced by that Statement.

f. Paragraphs 31, 32, 35-37, 40(a), 41, and footnotes 18, 19, 21, 24, and 25 are superseded prospectively. (Refer to paragraph 27 of this Statement.)

23. In the last sentence of paragraph 47 of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, the phrase realized gains and losses is replaced by income as prescribed in FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan.

24. In the first sentence of paragraph 14 of FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, the phrase for purposes of applying paragraph 30 of that Statement is deleted.

25. FASB Technical Bulletins No. 79-6, Valuation Allowances Following Debt Restructuring, and No. 79-7, Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms, are superseded by this Statement.

Effective Date and Transition

26. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged. Previously issued annual financial statements shall not be restated. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated).

27. This Statement applies to all troubled debt restructurings involving a modification of terms. However, if a loan that was restructured in a troubled debt restructuring involving a modification of terms before the effective date of this Statement is not impaired based on the terms specified
by the restructuring agreement, a creditor may continue to account for the loan in accordance with the provisions of Statement 15 prior to its amendment by this Statement.

22. FAS 118 provides the following guidance:

Introduction and Background

1. FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, was issued in May 1993 and addresses the accounting by creditors for impairment of certain loans. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994.

2. The Board received several requests to delay the effective date of Statement 114 and to clarify how that Statement should be implemented. A delay was requested to allow more time to resolve implementation questions about the application of the income recognition provisions in paragraphs 17-19 of Statement 114 and to make the necessary changes to accounting systems.

3. This Statement amends Statement 114 to allow a creditor to use existing methods for recognizing interest income on impaired loans. To accomplish this, it eliminates the income recognition provisions in paragraphs 17-19 of Statement 114. As amended, Statement 114 does not address how a creditor should recognize, measure, or display interest income on an impaired loan. This Statement amends the disclosure requirements in Statement 114 to require information about the recorded investment in certain impaired loans and about how a creditor recognizes interest income related to those impaired loans.

4. Prior to the issuance of this Statement, Statement 114 provided for two alternative income recognition methods to be used to account for changes in the net carrying amount of an impaired loan subsequent to the initial measure of impairment. Under the first income recognition method, a creditor would accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense. Under the second income recognition method, a creditor would recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense. While those income recognition methods are no longer required, this Statement does not preclude a creditor from using either of those methods.

5. Statement 114 requires that a creditor recognize impairment of a loan if the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the impaired loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is equal to or greater than the recorded investment in the impaired loan, no impairment is recognized. This Statement does not change those requirements. When the net carrying amount of an impaired loan equals the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will affect only the classification of income (or expense) that results from changes in the measure of an impaired loan, not the total amount of income (or expense) recognized within a given reporting period. However, when a creditor's policies for recognizing interest income and for charging off loans result in a recorded investment in an impaired loan that is less than the present value of expected future cash flows discounted at the loan's effective interest rate (or, alternatively, the observable market price of the loan or the fair value of the collateral), this Statement will cause both the classification and the total amount of income (or expense) recognized within a given reporting period to be different from that which would have been determined in accordance with paragraphs 17-19 of Statement 114.

Standards of Financial Accounting and Reporting

Amendments to Statement 114

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6. Statement 114 is amended as follows:

   a. The following sentence is added after the second sentence of paragraph 8:

      For a loan that has been restructured in a troubled debt restructuring, the contractual
      terms of the loan agreement refers to the contractual terms specified by the original
      loan agreement, not the contractual terms specified by the restructuring agreement.

   b. In the first sentence of paragraph 11, impaired loans is replaced by impairment of a
      loan.

   c. In the last sentence of paragraph 12, those impaired loans is replaced by impairment of
      those loans.

   d. In the last sentence of paragraph 13, measure of the impaired loan is replaced by
      present value of expected future cash flows (or, alternatively, the observable market
      price of the loan or the fair value of the collateral).

   e. In the first sentence of paragraph 14, measures an impaired loan using is replaced by
      bases its measure of loan impairment on.

   f. In the first sentence of paragraph 15, measures an impaired loan using is replaced by
      bases its measure of loan impairment on.

   g. Paragraph 17 is replaced by the following:

      This Statement does not address how a creditor should recognize, measure, or
      display interest income on an impaired loan. Some accounting methods for
      recognizing income may result in a recorded investment in an impaired loan that is
      less than the present value of expected future cash flows (or, alternatively, the
      observable market price of the loan or the fair value of the collateral). In that case,
      while the loan would meet the definition of an impaired loan in paragraph 8, no
      additional impairment would be recognized. Those accounting methods include
      recognition of interest income using a cost-recovery method, a cash-basis method, or
      some combination of those methods. The recorded investment in an impaired loan
      also may be less than the present value of expected future cash flows (or,
      alternatively, the observable market price of the loan or the fair value of the collateral)
      because the creditor has charged off part of the loan.

   h. Paragraphs 18 and 19 are deleted.

   i. Paragraph 20 is replaced by the following paragraphs:

      A creditor shall disclose, either in the body of the financial statements or in the
      accompanying notes, the following information about loans that meet the definition of
      an impaired loan in paragraph 8 of this Statement:

      a. As of the date of each statement of financial position presented, the total recorded
         investment in the impaired loans at the end of each period and (1) the amount of
         that recorded investment for which there is a related allowance for credit losses
         determined in accordance with this Statement and the amount of that allowance
         and (2) the amount of that recorded investment for which there is no related
         allowance for credit losses determined in accordance with this Statement
b. The creditor’s policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.

Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20(a) and 20(c) in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20(a) and 20(c) to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB Statement No. 5, Accounting for Contingencies, and with this Statement.

j. Paragraph 65 is deleted.

Effective Date and Transition

7. This Statement is effective concurrent with the effective date of Statement 114. Statement 114 is effective for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

The provisions of this Statement need not be applied to immaterial items.

23. FTB 81-6 provides the following guidance:

Question

1. Does Statement 15 apply to troubled debt restructurings of debtors involved in bankruptcy proceedings?

Background

2. Some confusion has arisen about the interaction of paragraph 10 and footnote 4 of Statement 15. Paragraph 10 indicates that the Statement applies to troubled debt restructuring consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. However, footnote 4 to that paragraph states that the Statement does not apply “. . .if, under provisions of those Federal statutes or in a quasi-reorganization or corporate readjustment (ARB No. 43, Chapter 7, Section A, “Quasi-Reorganization or Corporate Readjustment . . .”) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally.”
Response

3. Statement 15 does not apply to debtors who, in connection with bankruptcy proceedings, enter into troubled debt restructuring that result in a general restatement of the debtor's liabilities, that is, when such restructuring or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor's liabilities.

4. For example, companies involved with Chapter XI bankruptcy proceedings frequently reduce all or most of their indebtedness with the approval of their creditors and the court in order to provide an opportunity for the company to have a fresh start. Such reductions are usually by a stated percentage so that, for example, the debtor owes only 60 cents on the dollar. Because the debtor would be restating its liabilities generally, Statement 15 would not apply to the debtor's accounting for such reduction of liabilities.

5. On the other hand, Statement 15 would apply to an isolated troubled debt restructuring by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities.

24. FTB 80-2 provides the following guidance:

Question

1. In applying Statement 15, can a debt restructuring be a troubled debt restructuring for a debtor but not for the creditor?

Background

2. Paragraph 2 of Statement 15 states that “a restructuring of a debt constitutes a troubled debt restructuring for purposes of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.” Paragraph 7 points out that a debt restructuring is not necessarily a troubled debt restructuring simply because the debtor is experiencing some financial difficulties. That paragraph states in part:

For example, a troubled debt restructuring is not involved if (a) the fair value\(^2\) of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable;\(^3\) (b) the fair value of cash, other assets, or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable; (c) the creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate; or (d) the debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by nontroubled debtors. [Emphasis added.]

\(^2\) Defined in paragraph 13 [of Statement 15].

\(^3\) Defined in footnote 17 [of Statement 15].
Response

3. Yes, a debtor may have a troubled debt restructuring under Statement 15 even though the related creditor does not have a troubled debt restructuring. The debtor and creditor must individually apply Statement 15 to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred. Example (a) in paragraph 7 of Statement 15 identifies a type of debt restructuring that is not a troubled debt restructuring for purposes of the creditor's application of Statement 15; similarly, example (b) in paragraph 7 identifies a type of debt restructuring that is not a troubled debt restructuring for purposes of the debtor's application of Statement 15. Thus, Statement 15 establishes tests for applicability that are not symmetrical as between the debtor and the creditor when the debtor's carrying amount and the creditor's recorded investment differ.

Illustration

4. Creditor A makes a $10,000 interest-bearing loan to Debtor X and, when Debtor X later encounters financial difficulties, sells its receivable from Debtor X to Creditor B for $4,000 on a nonrecourse basis. Following the sale, the carrying amount of the loan payable by Debtor X would still be $10,000 and the recorded investment of the loan by Creditor B would be $4,000. If Debtor X subsequently transfers to Creditor B assets with a fair value of $5,500 in full settlement of the loan, that transaction would be a troubled debt restructuring for Debtor X because the fair value of the assets is less than the carrying amount of the loan, whereas Creditor B would not have a troubled debt restructuring because the fair value of the assets received exceeds its recorded investment in the loan.

25. FAS 91 provides the following guidance:

Fees and Costs in Refinancings or Restructuring

12. If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans.\textsuperscript{4} Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted.

13. If the refinancing or restructuring does not meet the condition set forth in paragraph 12 or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan shall consist of the remaining net investment in the original loan,\textsuperscript{5} any additional amounts loaned, any fees received, and direct loan origination costs set forth in paragraph 6 associated with the refinancing or restructuring.

\textsuperscript{4} The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

\textsuperscript{5} The net investment in the original loan includes the unpaid loan principal, any remaining unamortized net fees or costs, any remaining unamortized purchase premium or discount, and any accrued interest receivable.
14. Fees received in connection with a modification of terms of a troubled debt restructuring as defined in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, shall be applied as a reduction of the recorded investment in the loan. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

26. EITF 94-8 provides the following guidance, as summarized in the EITF Abstracts:

**ISSUE**

Statement 115 applies to marketable equity securities and to all debt securities. Technical Bulletin 94-1 clarifies that securities received in connection with a debt restructuring are subject to Statement 115.

In a debt restructuring, the creditor may receive a debt security issued by the original debtor with a fair value that differs from the creditor's basis in the loan at the date of the debt restructuring.

The issues are (1) what the initial cost basis of a debt security of the original debtor received in the restructuring of a loan should be and (2) how the creditor should account for any difference between the creditor's basis in the loan and the fair value of the security at the date of the restructuring.

**EITF DISCUSSION**

The Task Force reached a consensus that the initial cost basis of a debt security of the original debtor received as part of a debt restructuring should be the security's fair value at the date of the restructuring. Any excess of the fair value of the security received over the net carrying amount of the loan should be recorded as a recovery on the loan. Any excess of the net carrying amount of the loan over the fair value of the security received should be recorded as a charge-off to the allowance for credit losses. Subsequent to the restructuring, the security should be accounted for according to the provisions of Statement 115.

The Task Force also reached a consensus that a security received in a restructuring in settlement of a claim for only the past-due interest on a loan should be measured at the security's fair value at the date of the restructuring and accounted for in a manner consistent with the entity's policy for recognizing cash received for past-due interest. Subsequent to the restructuring, the security should be accounted for according to the provisions of Statement 115.

27. FTB 94-1 provides the following guidance:

**References:**

FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring

FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, paragraph 27

FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, paragraph 3

**Question**

1. For a loan that was restructured in a troubled debt restructuring involving a modification of terms, does Statement 115 apply to the accounting by the creditor (that is, investor) if the restructured loan meets the definition of a security in Statement 115?

**Background**
2. Statement 15 specifies the accounting for troubled debt restructuring and has been amended by Statement 114, which has changed a creditor's accounting for troubled debt restructuring involving a modification of terms. However, Statement 114 grandfathered certain previous troubled debt restructuring; that is, it does not require loans restructured prior to its effective date to be retroactively remeasured upon adoption of that Statement. Paragraph 27 of Statement 114 states that "if a loan that was restructured in a troubled debt restructuring involving a modification of terms before the effective date of this Statement is not impaired based on the terms specified by the restructuring agreement, a creditor may continue to account for the loan in accordance with the provisions of Statement 15 prior to its amendment by this Statement." (Although the term loan is defined in Statement 114 to encompass both loans that are securities and loans that are not, paragraph 6(d) of Statement 114 excludes all debt securities from the scope of that pronouncement.) Some have perceived an inconsistency between paragraph 27 of Statement 114 and paragraph 3 of Statement 115, which indicates that Statement 115 applies to all investments in debt securities.

Response

3. Statement 115 applies to all loans that meet the definition of a security in that Statement. Thus, any loan that was restructured in a troubled debt restructuring involving a modification of terms, including those restructured before the effective date of Statement 114, would be subject to the provisions of Statement 115 if the debt instrument meets the definition of a security. Paragraph 137 of Statement 115 defines a security as follows:

A share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Effective Date and Transition

4. The provisions of this Technical Bulletin are effective for financial statements issued after April 30, 1994.

Appendix

BACKGROUND INFORMATION AND CONSIDERATION OF COMMENTS RECEIVED ON THE PROPOSED TECHNICAL BULLETIN

5. The perceived inconsistency between paragraph 27 of Statement 114 and paragraph 3 of Statement 115 was identified during the Board's discussion of the applicability of Statement 115 to "Brady bonds" that were received in a troubled debt restructuring. The phrase Brady bonds refers to bonds issued to financial institutions by foreign governments (such as Mexico and Venezuela) under a program designed by Treasury Secretary Nicholas Brady in the late 1980s to help developing countries refinance their debt to those institutions.

6. If Statement 115 were not to apply to a debt security that was restructured in a troubled debt restructuring involving a modification of terms prior to the effective date of Statement 114, then the impairment provisions of neither Statement 114 nor Statement 115 would apply. Instead, the security would be accounted for under the provisions of Statement 15, which do not recognize the relevance of the time value of money or the security's fair value. For example, restructured
securities that otherwise would be classified as available-for-sale would be accounted for at amortized cost.

7. Proposed FASB Technical Bulletin No. 94-a, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring, was released for comment on January 4, 1994. Twelve comment letters were received on the proposed Technical Bulletin. Most of the comment letters expressed support for issuing the Technical Bulletin; a few suggested clarifications, which have been implemented.

28. EITF 87-18 provides the following guidance:

ISSUE

In connection with a troubled debt restructuring, a debtor, with the creditor's approval, sells the collateral, which has a fair value less than the creditor's net investment in the related loan, and invests the proceeds in a series of zero coupon bonds that are received and held by the creditor as collateral for the newly restructured loan. The bonds will mature at a value equal to each year's debt service requirement under the newly restructured terms.

The issue is whether the sale of collateral, the purchase of the zero coupon bonds, and their receipt by the creditor as collateral require the creditor to recognize a loss equal to the amount by which the net investment in the loan exceeds the fair value of the zero coupon bonds.

EITF DISCUSSION

The Task Force reached a consensus that the creditor should recognize a loss on the satisfaction of the loan and record an asset for the fair value of the zero coupon bonds. Under paragraph 28 of Statement 15, the loss would be measured as the amount by which the creditor's net investment in the loan exceeds the fair value of the assets received in full satisfaction of the debt. Most Task Force members considered the transaction to be an in-substance foreclosure or settlement of the loan pursuant to paragraph 34 of Statement 15. Some Task Force members commented that the creditor should not be able to avoid loss recognition by refraining from legal foreclosure even though the creditor has effectively acknowledged accepting possession of what is designated to be the collateral.

29. EITF 87-19 provides the following guidance:

ISSUE

In connection with a troubled debt restructuring, a debtor, with the creditor's approval, sells the collateral (real estate) on a contract for deed for a purchase price, the present value of which is less than the creditor's net investment in the related loan. The creditor does not release its lien on the property. The seller-debtor provides 100 percent financing for the third-party purchaser, with payment terms identical to the seller-debtor's obligation under the restructured terms. The third-party purchaser must make the monthly payments directly to the creditor and not to the seller-debtor.

The issue is whether the sale of collateral and related requirement for the purchaser to make payments directly to the creditor warrant the creditor's recognition of a loss related to the amount by which the net investment in the loan exceeds the fair value of the payments to be received from the purchaser.

EITF DISCUSSION
The Task Force reached a consensus that the creditor should recognize a loss on the disposition of the original loan and record an asset for the fair value of the payments to be received from the purchaser. Under paragraph 28 of Statement 15, the loss would be measured as the amount by which the creditor's net investment in the loan exceeds the fair value of the assets received in full satisfaction of the debt. Some Task Force members considered the transaction to be an in-substance foreclosure or settlement of the loan pursuant to paragraph 34 of Statement 15. Others viewed it as the addition or substitution of a debtor pursuant to paragraph 42 of Statement 15. Some Task Force members commented that the creditor should not be able to avoid loss recognition by refraining from legal foreclosure even though the creditor has effectively repossessed the original collateral by approving its sale and requiring the purchaser's payments to be made directly to the creditor.

30. EITF 89-15 provides the following guidance:

**ISSUE**

An enterprise that is experiencing financial difficulties proposes to exchange new debt for existing debt with the same creditor or creditors. Although the terms of the new debt are more favorable to the creditor than the terms of the existing debt, the new debt terms are not representative of and are less favorable to the creditor than prevailing terms for new borrowings by enterprises with similar credit ratings. This transaction may occur, for example, when an enterprise operating in a regulated environment wishes to increase its capital.

The issue is whether an exchange of new debt for existing debt under the circumstances described above should be considered an extinguishment of debt as described in Opinion 26 resulting in recognition of a gain by the debtor in the period of the exchange.

**EITF DISCUSSION**

The Task Force reached a consensus that no gain should be recognized in the circumstances described above. The Task Force concluded that an exchange of existing debt for new debt with the same creditor, the terms of which are not representative of and are less favorable to the creditor than prevailing terms for new borrowings by enterprises with similar credit ratings, results in a concession to the debtor by the creditor and should be accounted for by both parties as a modification of an existing obligation under the provisions of Statement 15. The Task Force agreed that the consensus reached regarding this Issue applies from the date of the September 21, 1989 meeting.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 3, Mortgage Loans, and Chapter 4, Real Estate
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans, and Chapter 4, Real Estate
- Accounting Practices and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners
- Issue Paper No. 24 - Discontinued Operations and Extraordinary Items
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities
- Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)
- Issue Paper No. 32 - Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)
Generally Accepted Accounting Principles
- FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loan and Initial Direct Costs of Leases
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
- FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures
- FASB Technical Bulletin 80-2, Classification of Debt Restructuring by Debtors and Creditors
- FASB Technical Bulletin 81-6, Applicability of Statement 15 to Debtors in Bankruptcy Situations
- FASB Technical Bulletin 94-1, Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring
- FASB Emerging Issues Task Force Issue No. 94-8, Accounting for Conversion of a Loan into a Security in a Troubled Debt Restructuring
- FASB Emerging Issues Task Force Issue No. 87-18, Use of Zero Coupon Bonds in a Troubled Debt Restructuring
- FASB Emerging Issues Task Force Issue No. 87-19, Substituted Debtors in a Troubled Debt Restructuring
- FASB Emerging Issues Task Force Issue No. 89-15, Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 37

Mortgage Loans

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance requires mortgage loans to be recorded on a reporting entity’s balance sheet at the unpaid principal balance plus any unamortized premium or origination fees or less any unaccreted discount. The carrying value of loans that are in default may be adjusted for unpaid interest and additional expenses incurred to protect the investment, providing that such amounts are deemed to be recoverable from the ultimate disposition of the asset. Costs to acquire or originate mortgage loans are expensed as incurred. Origination fees, including points, are deferred.

2. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of mortgage loans and related fees that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

3. For statutory accounting purposes, a mortgage loan shall be defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.) Mortgage loans meet the definition of assets as specified in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

Initial Investment

4. For mortgage loans originated by the reporting entity, the initial investment in mortgage loans shall be recorded at the principal amount of the loan net of any amounts deferred under the provisions of paragraphs 5 and 7 below. For mortgage loans purchased by a reporting entity, the initial investment shall be recorded as the amount paid to the seller. Accordingly, there may be a premium or discount on such loans resulting from a difference between the amount paid and the principal amount.

Loan Origination Fees

5. Loan origination fees shall be defined as fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan. The term includes, but is not limited to, points, management, arrangement, placement, application, underwriting, and other fees pursuant to a lending transaction. Nonrefundable loan origination fees shall not be recorded until received in cash. Nonrefundable fees representing points shall be deferred as part of the loan balance and amortized over the life of the loan in accordance with paragraph 8 of this issue paper. Nonrefundable fees other than points shall be recorded in the income statement upon receipt.
Loan Origination, Acquisition, and Commitment Costs
6. All costs incurred in connection with originating a loan, acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Commitment Fees
7. Commitment (or commitment standby) fees are fees paid to the reporting entity that obligate the reporting entity to make or acquire a loan or to satisfy an obligation of another party under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan is granted. If the loan is not granted, then the fees shall be recorded as investment income by the reporting entity when the commitment is no longer available. A fee paid to the reporting entity to obtain a commitment to be able to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 8 of this issue paper over the life of the loan as an adjustment to the investment income on the loan. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

Amortization
8. Premiums and discounts on acquired loans, and mortgage interest points and commitment fees (if such qualify for amortization as described in the previous paragraph) shall be recognized as an adjustment of yield over the life of the loan (i.e., the period of time until total principal proceeds of the loan are received in cash) so as to produce a constant effective yield each year to maturity. If the reporting entity holds a large number of similar loans for which the prepayments of principal are probable, (probable is used in the same context as in paragraph 4 in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets, which defines probable as the future event or events are likely to occur), and the timing and amount can be reasonably estimated, the reporting entity shall include estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. The amount recognized as an adjustment of yield shall be credited or charged to interest income in the calculation of net investment income.

Prepayments
9. Payments received in advance of due dates may produce prepaid interest which shall be recorded as a liability, Unearned Investment Income, on the reporting entity’s balance sheet. The portion of the payments received in advance of due dates that represent prepayments of principal shall be recorded as a reduction in the mortgage loan balance.

10. A mortgage loan may provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.

Interest Income
11. Interest income shall be recorded as earned and shall be included in investment income in the Summary of Operations. Interest income shall include interest collected, the change in interest income due and accrued and the change in unearned interest income as well as amortization of premiums, discounts and deferred fees as specified in paragraph 8.

Accrued Interest
12. When a loan is determined to be in default (per the contractual terms of the loan), the accrued interest on the loan shall be recorded as investment income due and accrued if deemed collectible. If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the
investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued.

Impairments

13. A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. According to the contractual terms means that both the contractual principal payments and contractual interest payments of the mortgage loan will be collected as scheduled in the mortgage agreement. A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to unrealized gain or loss. Subsequent to the initial measurement of the impairment, if there is a significant change (increase or decrease) in the net value of the collateral, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. For reporting entities required to maintain an asset valuation reserve (AVR), the unrealized gain or loss on impairments shall be included in the calculation of the AVR. If the impairment is other than temporary, a direct write down shall be recognized as a realized loss, and a new cost basis is established. This new cost basis shall not be changed for subsequent recoveries in value. Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

Construction Loans

14. A construction loan shall be defined as a mortgage loan of less than three years in term, made for financing the cost of construction of a building or other improvement to real estate, which is secured by the real estate. The principal amount of a construction loan shall be the amount of funds disbursed to the borrower. If, in accordance with the terms of the contract, interest is deferred until the maturity of the loan, the accrued interest shall be included in the balance of the loan outstanding. The impairment test in paragraph 13 should be applied to all construction loans, regardless of whether there are any actual or anticipated defaults. Accordingly, construction loans shall not be reported at an amount greater than the fair value of the property. The percentage of completion of the property shall be considered in determining fair values of property securing construction loans.

Disclosures

15. The reporting entity shall make the disclosures for impaired loans as required by paragraph 20 of FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), as amended by paragraph 6(1) of FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114 (FAS 118) in the annual audited statutory financial reports only. This is included in the Relevant GAAP Guidance section below.

16. The following additional disclosures shall also be made in the financial statements:
   b. Concentrations of credit risk in accordance with Issue Paper No. 27,
   c. Description of the valuation basis of the mortgage loans,
d. Information on the minimum and maximum rates of interest received for new loans made by category,
e. Maximum percentage of any one loan to the value of security at the time of the loan,
f. Total carrying amount of mortgages with interest 180 days past due and the amount of interest past due thereon. Disclose the carrying amount and number of mortgage loans where interest has been reduced, by percent reduced and
g. Taxes, assessments, and amounts advanced not included in the mortgage loan total.

DISCUSSION

17. The conclusion differs with current statutory guidance in that loan origination fees shall be recorded in the income statement, except for points which will be deferred as part of the loan balance. Also, prepayment penalties are to be recorded as investment income. It rejects FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring and Initial Direct Costs or Leases (FAS 91) and FASB Emerging Issues Task Force Issue No. 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations, which provides that certain origination costs be deferred. It adopts FAS 114 and 118 for collateral dependent loans (FAS 114 and FAS 118 apply to loans other than mortgage loans), with the following modifications:

a. Impairment to be measured based on the fair value of the collateral less costs to obtain and sell, whereas that is just one option under FAS 114; and
b. The reporting entity is required to record any other than temporary impairment as a realized loss and shall not record subsequent recoveries in fair value.

The conclusion also adopts FASB Emerging Issue Task Force Issue No. 84-19, Mortgage Loan Payment Modifications, which considers the effects of accelerated payments. The conclusion rejects AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans, which provides alternative accounting for the loan balance under the cost recovery method in circumstances where the amounts, and timing of collections and the ultimate collectibility of the acquisition amount of the loan are not probable. This method is not consistent with the impairment provisions established by paragraph 13 of this issue paper.

18. Recording mortgage loans as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similar nature to bonds, recording the mortgage loans at amortized cost is consistent with the principles used to record bonds at amortized cost.

19. Requiring reporting entities to defer commitment fees until the loan commitment terminates is more conservative than the GAAP treatment which allows for income recognition during the commitment period if the likelihood that the commitment will be exercised is remote.

20. Prepayment penalties represent consideration for interest income not received on a loan due to the prepayment. If that interest had been received it would have been recorded as investment income, therefore, it is appropriate to record the prepayment penalties as investment income. This is different from the current statutory guidance which allows a reporting entity to record the penalties as either investment income or realized capital gains.

21. By requiring reporting entities to reflect impairments in the value of a loan, the conclusion above is consistent with other issue papers on invested assets (e.g., bonds, common stock, preferred stock), which also require a reporting entity to record any impairment of an invested asset. It is also more conservative than allowing the reporting entity to continue to carry the impaired loan at amortized cost,
when it is probable that the reporting entity will not receive the invested funds in accordance with the terms of the original agreement.

Drafting Notes/Comments
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due and Accrued.
- Accounting for foreclosed assets is addressed in Issue Paper No. 36 - Troubled Debt Restructurings.
- Loan-backed and structured securities are addressed in Issue Paper No. 43 - Loan-backed and Structured Securities.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
22. The Accounting Practices and Procedures Manual for Life and Accident and Health contains the statutory guidance for the accounting for mortgage loans. Excerpts from Chapter 3, Mortgage Loans, are as follows:

Valuation

Mortgage loans when acquired are recorded in the general ledger at the amount of unpaid principal balance. However, if they are acquired at a discount or premium, entries for the amount of such discount or premium may be made in separate ledger accounts. If so, the net book value of mortgage loans consists of the unpaid balances plus any unamortized premium balances and less any unamortized discount.

Requirements for valuation of investments for reporting purposes indicate that mortgage loans that are not in default (regarding either principal or interest) should be valued at the unpaid principal balance. Further, mortgage loans acquired at a premium or at a discount are to be valued at amortized cost (i.e., net book value).

Premium amortization or discount accretion over the full term of a loan normally implies the use of a method that produces a constant effective yield each year to maturity. However, if the period of amortization of accretion is relatively short, a straight-line method may be used.

For loans that are in default, being voluntarily conveyed, or being foreclosed, the carrying value may be adjusted for unpaid interest and additional expenses, such as insurance, taxes and legal fees that have been incurred to protect the investment or to obtain clear title to the property to the extent that such amounts are deemed to be recoverable from the ultimate disposition of the property. However, if such interest and costs cannot reasonably be expected to be recovered, they should not be added to the carrying value, and the cost should be expensed.

If, when reporting mortgage loans in default, the values of real estate have declined to less than the unpaid principal balances, an appropriate valuation reserve should be established to reflect the expected uncollectible amount.

Mortgage loans that are in default, or which are under foreclosure proceedings, continue to be classified as mortgage loans. Loans for which foreclosure proceedings have been completed, even to the extent of the court granting title to the mortgages, may temporarily retain their status as mortgage loans, since in some states the mortgagor still has the privilege of redeeming the mortgage during a stated redemption period. During this period, the loan may remain classified as a mortgage loan until the insurance company obtains clear title. The asset is then transferred to the real estate account.
Interest

Interest income on mortgage loans is recorded when earned during any reporting period. An “inventory” of due and accrued interest must be determined at the end of each reporting period. Interest income includes adjustments for amortization or the accrual of discount.

A portion of the interest due and accrued on mortgage loans may require treatment as a nonadmitted asset for reporting purposes. In general, amounts over one year past due are nonadmitted. In practice, some companies consider that interest past due for periods of less than one year indicates future uncollectibility, and may make a provision against operations for such amounts to establish an appropriate reserve. Alternatively, some companies may cease accrual of interest on loans that default on any payment. Therefore, the amount of due and accrued interest that is considered to be a nonadmitted asset depends on the policy regarding accrual determination, and whether reserves have been established by charges to operations. In the case of mortgage loans on which foreclosure action is pursued, delinquent interest may be recovered from the amount, if any, by which the proceeds on the eventual sale of the property exceed the unpaid principal balance.

Contingent interest represents income generated through the occurrence of specific economic events in relation to the borrower. For example, contingent interest may become payable upon the attainment of a given level of cash flow or income. Contingent interest may be reported as income when received or accrued. The proper accrual of such income does, however, require an analysis of the applicable provisions in the underlying agreement and the verification that the prerequisite conditions have been met.

Payments

Payments on mortgage loans may be received in advance of due dates. Such payments may produce prepaid interest which is considered unearned and is recorded as a liability in the annual statement.

Companies that use servicing agents for their mortgage loans should report the “Interest Due and Accrued” asset on the balance sheet consistently with the income statement treatment of the charge for servicing costs. If interest income is reported net of servicing costs, which is usual when the servicing agent fee is based on a percentage retention of each interest payment, then the interest receivable in the balance sheet should be net of the related servicing costs. If interest is reported gross, with the servicing costs reported as an expense item, then interest due and accrued should be reflected as an asset at the gross amount, with an appropriate liability to reflect the related servicing cost accrual.

Amounts paid to the insurance company by the mortgagor to cover future tax payments, insurance premiums, and other costs related to the property requires the creation of escrow accounts in the general ledger to record these liabilities. If such amounts are held by the servicing agents, they should be reported on the insurance company's balance sheet both as an asset and as a liability when they produce income for the insurance company. This may occur if the servicing agent invests the escrow funds and is required to remit the income (or portion thereof) to the insurance company.

Prepayment penalties

Some mortgage loans provide for a prepayment penalty or acceleration fee in the event the loan is liquidated prior to its scheduled termination date. Prepayment charges are intended to compensate the lender for expenses incurred in granting the loan as well as the potential loss of future earnings. Prepayment penalties may be reported as realized capital gains or investment income.
Loan origination fees and costs

Brokerage commissions, finders’ fees, fees to cover loan processing and the like that are paid when acquiring mortgage loans usually are not significant and may be charged to operations when incurred. Points are additional fees and usually are expressed as a percentage of the funds disbursed. Points represent an adjustment of the loan interest rate to the current market. They should be deferred and amortized in the same manner as a premium paid on the mortgage.

Commitment fees

To obtain a commitment from the mortgage to make funds available at some time in the future, an applicant may pay a “commitment standby” fee to the mortgagee (e.g., an insurance company). This fee is returnable to the applicant if the loan is closed in accordance with the commitment. If the loan is not closed in accordance with the commitment, the fee becomes income to the mortgagee to cover the costs involved in making the funds available at the time the applicant requires the funds.

The applicant also may pay a commitment fee to a mortgagee to obtain a commitment to be able to borrow funds at a specified rate and with specific terms quoted in the commitment. As this commitment has value to the applicant, and the mortgagee has inurred costs in reviewing the applicant’s proposal, this fee is not returnable to the applicant unless the commitment is refused.

The commitment fee should be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield. If the commitment expires unexercised, the commitment fee should be recognized in income on the commitment expiration date. If the commitment fee is an insignificant adjustment to the yield, the commitment fee may be recognized in income at the time of the funding of the loan.


Generally Accepted Accounting Principles

24. GAAP guidance pertaining to a reporting entity’s accounting for mortgage loans is contained in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), as amended by FAS 114. Paragraph 47 of FAS 60, as amended by paragraph 23 of FAS 114 states:

Mortgage loans shall be reported at outstanding principal balances if acquired at par value, or at amortized cost if purchased at a discount or premium, with an allowance for estimated uncollectible amounts, if any. Amortization and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for estimated uncollectible amounts relating to mortgage loans shall be included in income as prescribed in FASB Statement 114, Accounting by Creditors for Impairment of a Loan.

25. The guidance for the accounting for loan origination costs and commitment fees is contained in FAS 91. Pertinent excerpts are as follows:

Loan Origination Fees and Costs

5. Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield2 (interest income). Likewise, direct loan origination costs defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for a troubled debt restructuring). Loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.
2 Methods for recognition of deferred fees and direct loan origination costs over the life of the loan as an adjustment of yield are set forth in paragraphs 18-20.

6. Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower’s financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees’ total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

7. All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees’ compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

Commitment Fees and Costs

8. Except as set forth in subparagraphs (a) and (b) below, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred and, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment:

a. If the enterprise’s experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield.

b. If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

9. Direct loan origination costs (described in paragraph 6) incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 8.

Purchase of a Loan or Group of Loans
15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan’s principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

16. In applying the provisions of this Statement to loans purchased as a group, the purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cash flows provided by the underlying loan contracts shall be used to apply the interest method, except as set forth in paragraph 19. If prepayments are not anticipated pursuant to paragraph 19 and prepayments occur or a portion of the purchased loans is sold, a proportionate amount of the related deferred fees and purchase premium or discount shall be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

Other

17. Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. Under the provisions of this statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a. If the loan’s stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan’s stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. If the loan’s stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. (Refer to Appendix B.)
6 The “interest” method is also described in paragraph 16 of APB Opinion No. 12, Omnibus Opinion--1967, in the first sentence of paragraph 15 of APB Opinion No. 21, Interest on Receivables and Payables, and in paragraphs 235-239 of FASB Concepts Statement No. 6, Elements of Financial Statements.

7 A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

20. Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

   a. For a loan that is payable at the lender’s demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender’s estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

   b. For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract.

If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement. 8

8 For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If
the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

Balance Sheet Classification

21. The unamortized balance of loan origination, commitment, and other fees and costs and purchase premiums and discounts that is being recognized as an adjustment of yield pursuant to this Statement shall be reported on the enterprise’s balance sheet as part of the loan balance to which it relates.

26. GAAP guidance on the accounting for the impairment of a loan is contained in FAS 114, as amended by FAS 118. Pertinent excerpts, as amended, are as follows:

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. For a loan that has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refers to the contractual terms specified by the original agreement, not the restructuring agreement.

13. When a loan is impaired as defined in paragraph 8 of this Statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan’s effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan’s observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

2 The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.

14. If a creditor bases its measure of loan impairment on a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan’s effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan). The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. If the loan’s contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan’s effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the
loan meets the impairment criterion in paragraph 8. The creditor’s choice shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor. Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows.

3 A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan’s credit quality, the effective interest rate is the discount rate that equates the present value of the investor’s estimate of the loan’s future cash flows with the purchase price of the loan.

15. If a creditor bases its measure of loan impairment on a present value calculation, the estimates of expected future cash flows shall be the creditor’s best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a creditor estimates a range for either the amount or timing of possible cash flows, the likelihood of the possible outcomes shall be considered in determining the best estimate of expected future cash flows.

16. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan’s expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

Disclosures

20. A creditor shall disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impaired loan in paragraph 8 of this Statement:

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with this Statement and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with this Statement

b. The creditor’s policy for recognizing interest income on impaired loans, including how cash receipts are recorded

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash-basis method of accounting during the time within that period that the loans were impaired.
Information about an impaired loan that has been restructured in a troubled debt restructuring involving a modification of terms need not be included in the disclosures required by paragraphs 20(a) and 20(c) in years after the restructuring if (i) the restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk and (ii) the loan is not impaired based on the terms specified by the restructuring agreement. That exception shall be applied consistently for paragraphs 20(a) and 20(c) to all loans restructured in a troubled debt restructuring that meet the criteria in (i) and (ii).

For each period for which results of operations are presented, a creditor also shall disclose the activity in the total allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with FASB No. 5, Accounting for Contingencies, and with this Statement.

27. FASB Emerging Issue Task Force Issue No. 84-19, Mortgage Loan Payment Modifications is adopted. Pertinent excerpts are as follows:

**EITF 84-19 ISSUE**
The borrower and lender enter into an agreement whereby the borrower increases his mortgage payments for a specified period, at the conclusion of which the lender forgives a portion of the remaining principal on the loan. The borrower may terminate the arrangement at any time but receives no principal reduction if he makes less than 12 consecutive increased payments.
The issue is how the lender should account for the portion of principal that may be forgiven.
1. Should the lender assume that the accelerated payments will be made to maturity and discount such accelerated payments using the current interest rate, thus recording a loss?
2. Should the lender assume that only 12 consecutive increased payments will be made and that other payments to maturity will be at the original rate and discount all payments using the current interest rate, thus recording a smaller loss?
3. Should the discount only be recorded as a loss when the borrower has made all the payments required or should the discount be accrued as a loss pro rata over the 12-month period?

**EITF 84-19 DISCUSSION**
The Task Force reached a consensus that, assuming it is probable that the borrower will continue to make the increased payments for the specified period, the expense relating to the partial forgiveness should be accrued over the period of increased payments. Task Force members indicated that this approach to the accounting has already been consistently applied in practice.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 3, Mortgage Loans
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 3, Mortgage Loans
- Issue Paper No. 34 - Investment Income Due and Accrued
**Generally Accepted Accounting Principles**
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
- FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114*
- FASB Emerging Issues Task Force Issue No. 84-19, *Mortgage Loan Payment Modifications*
- FASB Emerging Issues Task Force Issue 88-17, *Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations*
- AICPA Practice Bulletin 6, *Amortization of Discounts on Certain Acquired Loans*

**State Regulations**
- State regulations contain numerous references to mortgage loans. Due to the volume, specific references to each state regulation have not been reproduced in this issue paper.
Statutory Issue Paper No. 38

Acquisition, Development and Construction Arrangements

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Reporting entities may enter into real estate acquisition, development and construction (ADC) arrangements to finance the construction costs in which they have virtually the same risks and potential rewards as those of owners or joint venturers. In some instances, it may be inappropriate to account for such arrangements as loans. Current statutory accounting provides no specific guidance on the accounting for ADC arrangements. GAAP provides specific guidance for when to treat such arrangements as real estate/joint venture investments rather than as loans. This issue paper establishes statutory accounting principles for ADC arrangements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. This paper provides guidance on when to account for ADC arrangements as mortgage loans and when to account for ADC arrangements as investments in real estate or real estate joint ventures. ADC arrangements shall be defined as lending agreements that are made to the owner of property to finance the acquisition, development and construction of real estate projects on the property in which the lender participates in expected residual profits. Expected residual profit is the amount of profit, whether called interest or another name (e.g., equity kicker) above a reasonable amount of interest and fees expected to be earned by the lender. ADC arrangements shall include participations in loans and purchased loans that meet that definition of ADC arrangements.

3. If the lender is expected to receive over 50% of the expected residual profits of the project, the ADC arrangement shall be classified and accounted for as an investment in real estate in accordance with Issue Paper No. 40 - Real Estate Investments.

4. If the lender is expected to receive 50% or less of the expected residual profits, the ADC arrangement shall be classified and accounted for as a loan or as a real estate joint venture, depending on the circumstances. If any of the characteristics in paragraph 9.b. through 9.e. of AcSEC Practice Bulletin 1, Exhibit I, ADC Arrangements (PB1), which is excerpted in the Relevant GAAP Guidance section in paragraph 10 below, or if a qualifying personal guarantee (as defined in PB1) is present, the ADC arrangement shall be classified and accounted for as a construction loan in accordance with Issue Paper No. 37 - Mortgage Loans. Otherwise, the ADC arrangement shall be classified and accounted for as a real estate joint venture in accordance with Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies.

5. The factors that are evaluated in determining the accounting treatment at inception may subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement shall be periodically reassessed, as described in paragraph 20 of PB1 contained in paragraph 10 below. Any changes in classification shall result in a reclassification of the asset at the amount the asset should be reported at under its new classification with the net effect, if any, charged to income in the period that the change in classification is made.
6. Regardless of whether an ADC arrangement is accounted for as an investment in real estate, a joint venture, or a mortgage loan, the ADC arrangement meets the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and is an admitted asset to the extent it conforms to the requirements of this issue paper.

DISCUSSION

7. The conclusion above adopts PB1. Classifying and accounting for ADC arrangements in accordance with their economic substance rather than their form is consistent with a regulator’s need for meaningful and comparable financial information, as stated in the Statement of Concepts. Furthermore, the conclusion is consistent with the conservatism concept in the Statement of Concepts in as much as certain ADC arrangements that otherwise would be accounted for as loans will be accounted for as investments in real estate. Accordingly, to the extent that the ADC project is expected to incur a loss, the lender shall recognize its share of those losses. The conclusion above also adopts FASB Emerging Issues Task Force No. 86-21, Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property.

Drafting Notes/Comments
- ADC arrangements may involve related parties, in which case Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties should also be followed.
- Issue Paper No. 37 - Mortgage Loans addresses accounting for mortgage loans, including construction loans, and addresses impairment and disclosures.
- Issue Paper No. 40 - Real Estate Investments addresses accounting for real estate investments, including how to account for sales of real estate, construction of real estate, impairment and disclosures.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. Statutory literature does not specifically address ADC arrangements.

9. Some states specifically prohibit the investment in construction/developmental real estate. For example, Texas Insurance Code Chapter 3, Life, Health and Accident Insurance, Subchapter C, Reserves and Investments, Art. 3.33 Sec. 4 (1)(2) states:

... nothing in this article shall allow ownership of, development of, or equity interest in any residential property or subdivision, single or multiunit family dwelling property, or undeveloped real estate for the purpose of subdivision for or development of residential, single, or multiunit family dwellings, except acquisitions as provided in Subdivision (4) below, and such ownership, development, or equity interests shall be specifically prohibited;

Generally Accepted Accounting Principles
10. The accounting for ADC arrangements under GAAP is governed by PB1 as follows:

1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

Scope
2. This notice applies only to those ADC arrangements in which the lender participates in expected residual profit, as further described below.

Expected Residual Profit

3. Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender’s share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures

8. As stated in the “Scope” section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender’s participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

   a. The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.

   b. The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.

   c. The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.

   d. The financial institution’s only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.

   e. In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain
refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.

f. The arrangement is structured so that foreclosure during the project’s development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

Characteristics of ADC Arrangements Implying Loans

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

a. The lender participates in less than a majority of the expected residual profit.

b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.

c. The lender has 1) recourse to substantial tangible, salable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.

d. A take-out commitment for the full amount of the financial institution’s loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.

e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide
necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

   a. Liquidity as well as net worth of the guarantor--There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor’s net worth consists primarily of assets pledged to secure other debt.

   b. Guarantees provided by the guarantor to other projects--If the financial statements do not disclose and quantify such information, inquiries should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project’s assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as sweat equity. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

   a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) no. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects,\(^N1\) and SFAS no. 66, Accounting for Sales of Real Estate.\(^N2\)

\(^{N1}\) Statement of Financial Accounting Standards (SFAS) no. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (Stamford: FASB, 1982).

\(^{N2}\) SFAS no. 66, Accounting for Sales of Real Estate (Stamford: FASB, 1982).
b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9, b through e, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.

1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts,\textsuperscript{N3} and the AICPA audit and accounting guide entitled, Savings and Loan Associations,\textsuperscript{N4} provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

\textsuperscript{N3} Statement of Position SOP no. 75-2, Accounting Practices of Real Estate Investment Trusts (New York: AICPA, 1975).

\textsuperscript{N4} Committee on Savings and Loan Associations, Savings and Loan Associations (New York: AICPA, 1979).

2. In the case of a real estate joint venture, the provisions of SOP no. 78-9, Accounting for Investments in Real Estate Ventures,\textsuperscript{N5} and SFAS no. 34, Capitalization of Interest Cost,\textsuperscript{N6} as amended by SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method,\textsuperscript{N7} provide guidance for such accounting. In particular, paragraph 34 of SOP no. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

\textsuperscript{N5} SOP no. 78-9, Accounting for Investments in Real Estate Ventures (New York: AICPA, 1978).

\textsuperscript{N6} SFAS no. 34, Capitalization of Interest Cost (Stamford: FASB, 1979).

\textsuperscript{N7} SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method (Stamford: FASB, 1982).

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

Other Considerations

18. Transactions have occurred in which the lender’s share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.
19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender’s position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

21. If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

22. Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollectible principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor’s purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

23. Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 37 - Mortgage Loans
- Issue Paper No. 40 - Real Estate Investments
- Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies

**Generally Accepted Accounting Principles**
- AcSEC Practice Bulletin 1, Exhibit I, *ADC Arrangements*
- FASB Emerging Issues Task Force No. 86-21, *Application of the AICPA Notice to Practitioners regarding Acquisition, Development, and Construction Arrangements to Acquisition of an Operating Property*

**State Regulations**
Statutory Issue Paper No. 39

Reverse Mortgages

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A reverse mortgage is a loan against home equity that guarantees cash advances to the homeowner and requires no repayment until a future time, usually when the borrower dies, sells the property or permanently moves. The term reverse mortgage is used to describe the timing of repayment of the mortgage obligation which is at the end of the contractual period (i.e., the mortgagee does not repay the obligation until the underlying collateral is liquidated). The proceeds from the sale of the property are used to pay off the balance of the loan. The borrower’s obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrower’s estate. Usually, the borrower receives an annuity payment either (a) for as long as the borrower lives or (b) until a set percentage of the value of the collateral is reached. In the first type, there is mortality risk, as well as the collateral, interest rate, and credit risk found in traditional mortgage loans.


3. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting of reverse mortgages that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. For purposes of this issue paper, a reverse mortgage loan shall be defined as a non-recourse loan with the following characteristics:

   a. It is secured by a mortgage against the primary residence of the borrower;

   b. It guarantees a stream of cash disbursements to the borrower, either for the life of the borrower with no limit or up to a set percentage of the value of the residence or is a line of credit which the borrower can draw upon as needed; and

   c. It has no maturity date and requires no repayment until one of the following events occur:

      i. The borrower dies,

      ii. The borrower sells the residence,

      iii. The residence ceases to be the borrower’s primary residence, or

      iv. The borrower terminates the loan by paying back the outstanding balance.

5. A reverse mortgage meets the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and is an admitted asset to the extent it conforms to the requirements of
this issue paper. As such, it shall be recorded as an other invested asset on the reporting entity’s balance sheet and Schedule BA, Other Long-Term Invested Assets, of the Annual Statement.

6. The accounting and reporting requirements for reverse mortgages shall be the same as those contained in paragraph 10 below. A reverse mortgage shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the reverse mortgage. “According to the contractual terms” means that both the contractual principal payments and contractual interest payments of the loan will be collected as specified in the reverse mortgage agreement. The three major categories of risk affecting reverse mortgages are described in paragraph 10. Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections, and evaluation of risk are to be reviewed and updated at least annually with any resulting adjustment made to the valuation allowance (contra-asset) and unrealized gains and losses, if the impairment is temporary. Subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the risk factors affecting the value of the mortgage, the reporting entity shall adjust the valuation allowance; however, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan. The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of the valuation allowance, while the former term is not. The recorded investment (including accrued interest, net deferred loan fees, and unamortized premium or discount) in the loan does, however, reflect any direct write down of the investment. If the impairment is other than temporary, a direct write down (charge-off) shall be recognized and a new cost basis is established. Direct write-downs for other than temporary impairments of reverse mortgages shall also be included in realized losses. This new basis shall not be changed for subsequent recoveries in fair value.

7. The following disclosures shall be made for reverse mortgages in the financial statements:
   a. A description of the reporting entity’s accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve,
   b. The reserve amount which is netted against the asset value,
   c. Investment income or loss recognized in the period as a result of the re-estimated cash flows, and
   d. General information regarding the reporting entity’s commitment under the agreement.

DISCUSSION

8. This issue paper adopts current statutory guidance.

9. Though, at the time a reverse mortgage agreement is ratified, the reporting entity has agreed to make payments to the borrower, this does not meet the definition of a liability, as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). Issue Paper No. 5 defines a liability as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). By making payments to the borrower, the reporting entity is converting one asset (cash) to another (an outstanding reverse mortgage). It is, therefore, not sacrificing any economic benefit and is not incurring a liability up to the amount that the reporting entity can record as an asset (i.e., the value of the collateral).

Drafting Notes/Comments
- Accounting for real estate acquired in satisfaction of debt is addressed in Issue Paper No. 40 - Real Estate Investments.
- Accounting for Mortgage Loans is addressed in Issue Paper No. 37 - Mortgage Loans.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. The Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the March 13, 1995 meeting contained the following to be added to the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies:

Description

Reverse mortgages are primarily designed to allow senior citizens to convert home equity into cash without selling their home. A reverse mortgage is a non-recourse loan secured by the borrower’s owner occupied principal residence. Loan proceeds are based on the current fair market value of the home and the age of the borrower and may be disbursed in a lump sum or periodically to provide cash flow to the borrower. In consideration of those payments, the borrower exchanges all or part of a claim to home equity.

Principal and interest payments on the loan are deferred until the borrower moves, sells the property or dies. The loan is then repaid in a lump sum with proceeds from the sale of the property. The borrower’s obligation is limited to the value of the home at the time of sale and the lender has no recourse to other assets of the borrower or the borrowers estate.

Reverse mortgages are reported on Schedule BA of the Annual Statement as “Investment in Reverse Mortgages”.

Payments can be structured in many different ways to fit the financial needs of the borrower. In some contracts the borrower shares a percentage of the home appreciation with the lender. Three common types of payment plans are:

1. Tenure plan - borrower receives fixed monthly payments until the borrower permanently moves, sells the property or dies.
2. Term plan - borrower receives fixed monthly payments for a specified period of time.
3. Line of Credit - borrower draws upon a pre-determined line of credit as needed.

Authorization and Limitation

To be considered admitted assets, investments in reverse mortgages are limited to first lien mortgages only. Reverse mortgages also may be subject to mortgage loan limitations established by the state of domicile, including loan to value limitations. Loan to value calculations will be based on the most current appraisal of the collateral. Reappraisal of the collateral is required when existing reverse mortgages are purchased by an insurer.

Origination Expenses and Fees

All expenses associated with entering into reverse mortgages shall be recognized immediately as investment expense.

Revenue associated with originating or otherwise acquiring reverse mortgages, including non-refundable fees, shall be amortized to investment income on a straight line basis over the period from inception to the expected maturity date.

Generally, fees are not paid by the borrower at the time of closing but become payable when the outstanding balance of the reverse mortgage becomes due. In these situations, no accounting entries are recorded at the time of closing. Investment income will be recognized and the outstanding balance of the loan will increase as the fees are amortized.
If fees are paid by the borrower at the time of closing, a liability should be established. Investment income will be recognized and the liability will decrease as the fees are amortized.

Interest Income and Accrued Interest Receivable

Interest is payable by the borrower when the outstanding balance of the reverse mortgage becomes due. Accrued interest should be calculated on the outstanding balance of the loan on a monthly basis. As it is earned, accrued interest should be recorded to investment income and added to the outstanding balance of the loan.

Valuation

The outstanding balance of the reverse mortgage will include the accumulation of amounts disbursed, accrued interest and amortized origination fees (origination fees not paid by the borrower at the time of closing). Neither the fair market value of the underlying collateral nor the liability for future cash payments guaranteed by the lender are recorded. They are, however, considered in cash flow projections and to the extent that estimated future cash payments exceed estimated future cash receipts, a valuation reserve is established. Future appreciation in property value beyond the valuation date is not included in the projection of cash receipts.

The lender’s equity in the appreciation of the property, if any, is not recorded until realized upon the sale of the home.

The three major categories of risk affecting reverse mortgages are described below:

1. Mortality risk - risk of loan payments extending beyond the borrower’s original projected life expectancy.

   Since most reverse mortgages guarantee a continuing monthly payment to the borrower, there is the possibility that the borrower will collect cash payments and accrue interest exceeding the appreciated value of the collateral. In situations where loan payments extend beyond the borrower’s original projected life expectancy, the insurance company will experience a diminished yield, and may experience a loss. Reverse mortgage contracts should be combined into groups which are of sufficient size to provide an actuarially and statistically credible basis for estimating life expectancy to project future cash flows.

2. Collateral Risk - risk of deterioration in the value of the collateral such that it is insufficient to cover the loan balance. This risk must be evaluated loan-by-loan and is based on information obtained from periodic real estate appraisals, as required by the state of domicile, and other pertinent information.

3. Interest Rate Risk - risk of interest rates rising on adjustable rate reverse mortgages to the extent that accrued interest creates a collateral risk.

Reverse mortgages subject to these risks shall be reported net of an appropriate actuarial reserve. The assumptions, cash flow projections and evaluation of risk are to be reviewed and updated at least annually, with any resulting adjustment made to the reserve. Assumptions should be applied consistently to similar loans.

Disclosure Requirements

The following should be disclosed in footnote 2, Basis of Valuation of Invested Assets:

1. A description of the company’s accounting policies and methods, including the statistical methods and assumptions used in calculating the reserve.

2. The reserve amount which is netted against the asset value.

3. Investment income or loss recognized in the period as a result of the re-estimated cash flows.
4. General information regarding the insurer’s commitment under the agreement.

Effective Date

These accounting and reporting guidelines are effective for the year ending December 31, 1995.

Generally Accepted Accounting Principles
11. GAAP does not specifically address reverse mortgages. GAAP guidance addressing mortgage loans is contained in Issue Paper No. 37 - Mortgage Loans.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4)
  Task Force minutes of the March 13, 1995 meeting
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 37 - Mortgage Loans
- Issue Paper No. 40 - Real Estate Investments

Generally Accepted Accounting Principles
None

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 40

Real Estate Investments

STATUS:
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for real estate investments is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. However, the Accounting Practices and Procedures Manuals contain no comprehensive guidance on accounting for sale of real estate or for real estate construction projects.

2. GAAP guidance for real estate is established in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FASB Statement No. 60), FASB Statement No. 66, Accounting for Sales of Real Estate (FASB Statement No. 66), FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (FASB Statement No. 67), FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, and AICPA Statement of Position 92-3, Accounting for Foreclosed Assets (SOP 92-3). Current statutory guidance is similar to GAAP, except that GAAP requires recognition of impairment in the value of the investments through a writedown to the appropriate basis with a charge to realized gains and losses. Current statutory accounting guidance states that “Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation.” The current statutory guidance gives reporting entities three options when an impairment is recognized: a) write down the investment real estate, b) nonadmit part of the value, or c) establish a reserve for specific properties as a liability.

3. The purpose of this issue paper is to establish statutory accounting principles for real estate investments that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Real estate investments shall be defined as direct-owned real estate properties acquired in exchange for consideration (including but not limited to cash, a contract for deed or mortgage, or other non-cash consideration), obtained through foreclosure or voluntary conveyance in satisfaction of a mortgage loan, or received as contributed surplus. Real estate investments meet the definition of assets defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

5. Real estate investments include real estate occupied by the company, which is defined in Issue Paper No. 23 - Property Occupied by the Company, and certain acquisition, development and construction arrangements (ADC) as defined in Issue Paper No. 38 - Acquisition, Development and Construction Arrangements (Issue Paper No. 38).

6. Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of related encumbrances:
7. Encumbrances represent outstanding mortgages or other debt related to the real estate investment and any unpaid accrued acquisition or construction costs. Interest expense shall be included in investment expenses.

8. The cost of real estate represents the fair market value of the consideration exchanged plus any costs incurred to place the real estate asset in usable condition, including but not limited to, brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, any additional expenditures made for equipment and fixtures that are made a permanent part of the structure and certain interest costs as provided for in Issue Paper No. 44 - Capitalization of Interest. Where cost includes both land and building, the cost shall be allocated among the assets purchased based on the relative values determined using appraisals, as described in paragraph 12 below. The cost shall be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property. The cost of real estate which has been foreclosed upon shall be initially established in accordance with Issue Paper No. 36 - Troubled Debt Restructurings. The cost of contributed real estate shall be initially established in accordance with Issue Paper No. 73 – Nonmonetary Transactions as a nonreciprocal transfer.

9. The cost of property included in real estate investments, other than land, shall be depreciated over the estimated useful life, not to exceed fifty years. Depreciation expense shall be included in investment expenses.

10. Properties occupied by the reporting entity and properties held for the production of income shall be carried at depreciated cost less encumbrances unless events or circumstances indicate the carrying amount of the asset (amount prior to reduction for encumbrances) may not be recoverable. Paragraph 5 of FAS 121 provides examples of events or changes in circumstances which indicate that the recoverability of the carrying amount of properties occupied by the reporting entity or properties held for the production of income should be assessed. If the events or changes in circumstances set forth in paragraph 5 of FAS 121 are present or if other events or changes in circumstances indicate that the carrying amount of properties occupied by the company or properties held for the production of income may not be recoverable, the reporting entity shall determine whether an impairment loss must be recognized in accordance with paragraph 6 of FAS 121. Property occupied by the reporting entity shall be evaluated using the asset grouping approach of paragraph 8 of FAS 121. FAS 121 is excerpted in paragraph 37 of this issue paper. An impairment loss is measured as the amount by which the individual carrying amounts exceed the fair value of properties occupied by the company or properties held for the production of income. Fair value is determined in accordance with paragraph 12 of this issue paper. If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss.

11. Properties that the reporting entity has the intent to sell or is required to sell shall be classified as properties held for sale and carried at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property consistent with paragraph 16 of FAS 121. The intent to sell a property exists when management, having the authority to approve the action, has committed to a plan to dispose of the asset, either by sale or abandonment. Fair value of the asset shall be determined in accordance with paragraph 12 of this issue paper. Subsequent revisions to the fair value of the asset shall be accounted for in accordance with paragraph 17 of FAS 121.
12. The current fair value of real estate shall be determined on a property by property basis (i.e., increases in the fair value of one property shall not be used to offset declines in fair value of another) and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale (i.e., the buyer and seller acting prudently and knowledgeable with the price not affected by any undue stimulus). If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon an evaluation of all relevant data about the market, considering the following:

   a. A physical inspection of the premises,

   b. The present value of future cash flows generated by the property (Discounted Cash Flows), or capitalization of stabilized net operating income (Direct Capitalization),

   c. current sales prices of similar properties with adjustments for differences in the properties (Sales Comparison Approach),

   d. costs to sell the property if the reporting entity does not have the intent or ability to hold the real estate as an investment,

   e. replacement costs of the improvements, less depreciation, plus the value of the land (Cost Approach).

All appraisals obtained to determine fair market value of real estate investments shall be no more than five years old. However, if conditions indicate there has been a significant decrease in the fair market value of a property, then a current appraisal shall be obtained. Additionally, appraisals shall be obtained for real estate investments at the time of foreclosure or contribution. Contributed real estate shall be supported by an independent third party appraisal at the date of contribution. If either of the previous conditions exist but an appraisal has not been obtained, the related property shall be considered a nonadmitted asset until the required appraisals are obtained.

Income, Expenses, and Capital Improvements
13. Rental income on real estate leased is addressed in Issue Paper No. 22 - Leases, which requires that rental income be included in investment income. Expenses incurred in operating the real estate investment, including but not limited to, real estate taxes, utilities, and ordinary repair and maintenance, shall be charged to expense as incurred and included in investment expenses.

14. Expenditures that are necessary to put the asset back into good operating condition or to keep it in good operating condition, shall be charged to expense as incurred. Expenditures that add to or prolong the life of the property shall be added to the cost of the real estate (capitalized) and depreciated over the remaining estimated useful life of the property.

Sale of Real Estate
15. Recognition of profit on sales of real estate investments shall be accounted for in accordance with paragraphs 29, 33 and 34 below. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

   a. A sale is consummated,
b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property,

c. The seller's receivable is not subject to future subordination, and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

DISCUSSION

The calculation of the buyer's initial investment specified in subparagraph 9 of paragraph 29 below shall be modified to reflect that buyer's notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer's initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Real Estate Projects Under Development

16. Costs and initial rental operations of real estate projects under development, which include ADC arrangements accounted for as real estate under the provisions of paragraph 3 of Issue Paper No. 38, shall be accounted for in accordance with paragraph 30 below. Costs incurred in connection with real estate projects shall be expensed as incurred unless the criteria established in paragraph 30 are met. The admitted value of a real estate project, or parts thereof, held for sale or development and sale shall not exceed the estimated selling price in the ordinary course of business less estimated costs of completion (to stage of completion assumed in determining the selling price), holding, and disposal (net realizable value). If costs exceed net realizable value, capitalization of eligible costs shall continue, however, an allowance shall be provided to reduce the admitted value to estimated net realizable value.

17. The statutory principles in this issue paper are consistent with the current statutory guidance except as follows:

- Paragraph 11 requires real estate held for sale to be carried at the lower of fair value less estimated costs to sell or depreciated cost. There are at least two states, Nevada and Arizona, which allow real property to be carried in excess of depreciated cost if supported by an appraisal.

- Paragraphs 10 and 11 distinguish between real estate held for sale and real estate not held for sale. Paragraph 11 requires the fair market value of real estate held for sale to be reduced by estimated selling costs in determining admitted value.

- Paragraph 10 provides that impairments for properties occupied by the company and properties held for the production of income shall be recorded as a realized loss. After an impairment is recognized, the carrying amount of the asset shall be accounted for as its new cost. Current statutory guidance provides three options for recording valuation adjustments: (a) direct write-down of asset, (b) nonadmit part of the asset, or (c) establish a reserve liability.

- Paragraph 12 provides for the utilization of appraisals in determining fair market value. The Accounting Practices and Procedures Manual for Life and Accident and Health and for Property and Casualty Insurance Companies define the term “appraised value” but do not require the use of an appraisal to support valuation allowances. At least two states, Minnesota and Missouri, have regulations that require the use of appraisals for certain real estate properties.

- Paragraph 6 conforms the balance sheet categories to be consistent with FAS 121. These differ from those required on the Property and Casualty Annual Statement and those required on the
Life and Accident and Health Annual Statement. Real estate currently reported as “Other Properties” on the Property and Casualty Annual Statement shall be reported as “Properties held for the production of income” or “Properties held for sale.” Real estate currently reported as “Properties Acquired in the Satisfaction of Debt” on the Life and Accident and Health Annual Statement shall be reported as “Properties held for the production of income” or “Properties held for sale.”

- Paragraph 15 adopts the GAAP guidance for sales of real estate, which augments and clarifies the current statutory guidance on sales of real estate.

- Paragraph 16 adopts GAAP guidance for real estate construction projects; no current statutory guidance exists.

18. The statutory accounting principles established in this issue paper:

- Adopt FASB Statement No. 66, Accounting for Sales of Real Estate, with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer's initial investment. Additionally, as they relate to FASB Statement 66, the following are adopted: FASB Emerging Issues Task Force Issue 87-29, Exchange of Real Estate Involving Boot (EITF 87-29), FASB Emerging Issues Task Force Issue 86-6, Antispeculation Clauses in Real Estate Sales Contracts, FASB Emerging Issues Task Force Issue 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66, FASB Emerging Issues Task Force Issue 88-24, Effect of Various Forms of Financing under FASB Statement No. 66 and FASB Emerging Issues Task Force Issue 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds (EITF 87-9).

- This issue paper adopts FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages, FASB Emerging Issues Task Force No 89-13, Accounting for the Cost of Asbestos Removal, FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate, FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination, and FASB Emerging Issues Task Force No. 95-23, The Treatment of Certain Site Restoration /Environmental Exit Costs When Testing a Long-Lived Assets for Impairment.

- Adopt FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects. Foreclosed real estate held for sale should be valued as described within SOP 92-3, Accounting for Foreclosed Assets.

- Adopt SOP 92-1, Accounting for Real Estate Syndication Income and SOP 92-3, Accounting for Foreclosed Assets.

- Adopt FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, for real estate investments except for paragraphs 13, 14 c. and 14 d. which were rejected in Issue Paper No. 68 - Business Combinations and Goodwill.

- Reject Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, “Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes”

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:
Conservatism

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

Recognition

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

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

Drafting Notes/Comments

- Accounting for investments in real estate ventures are addressed in Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies.
- Accounting for lease and sale-leaseback transactions involving real estate transactions are addressed in Issue Paper No. 22 - Leases.
- Issue Paper No. 36 - Troubled Debt Restructurings addresses accounting for the foreclosure of real estate; this paper addresses how to account for foreclosed real estate after foreclosure.
- Issue Paper No. 34 - Investment Income Due and Accrued addresses requirements related to nonadmitted rental income due and accrued.
- Accounting for real estate occupied by the company is addressed in Issue Paper No. 23 - Property Occupied by the Company.
- Accounting for leasehold improvements is addressed in Issue Paper No. 31 - Leasehold Improvements Paid by the Reporting Entity as Lessee.
- Issue Paper No. 44 - Capitalization of Interest addresses capitalization of interest.
- Accounting for real estate property acquired by mortgage guaranty insurers in settlement of a claim is addressed in Issue Paper No. 88 – Mortgage Guaranty Insurance.
- Depreciation of assets, including acceptable and unacceptable methods and maximum lives and disclosures, will be addressed in Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

20. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies includes the following guidance in Chapter 4, Real Estate:

Directly-owned real estate is reported separately in the statutory financial statement. Holdings so reported are classified as properties (a) occupied by the company, (b) acquired in satisfaction of debt, and (c) investments in real estate. These classes may include real estate owned under contract of sale.

When real estate is owned indirectly through partnerships or joint ventures, it is reported as "Other Invested Assets" in the statutory financial statement.
Authorization and Limitations

Statutes and regulations promulgated by the states concerning limitations on investments in real property are widely divergent. Generally speaking, the thrust of these limitations is to provide an aggregate maximum investment value on holdings of real property. A typical example would be that real estate investments not exceed a stipulated percentage of total admitted assets or surplus. Also common among these limitations are provisions requiring the disposal of foreclosed properties within a certain period of time.

Cost

The cost of real estate acquired by purchase is the actual amount paid upon purchase, plus the costs incurred to place the real estate asset in usable condition. Elements of cost should also include brokerage fees, legal fees, demolition, clearing and grading, fees of architects and engineers, and any additional expenditures made for equipment and fixtures that are made a permanent part of the structure. Cost should be reduced by any amounts received for sales of rights or privileges in connection with the property or by any cash recoveries received after acquiring title to the property.

Where more than one property is acquired at a group price, or where the cost includes both land and building, the price paid must be allocated among the assets purchased. This normally is done on the basis of relative values, which may be determined by appraisals made for insurance purposes, by assessed valuations made for property tax purposes, by independent appraisal, or by some other reasonable method such as the previous owner’s percentage allocation or underwriting estimates.

If property is acquired in a non-cash transaction, the acquired property should be recorded at the fair market value of the property or other asset given if the market value of the property acquired cannot reasonably be determined.

In determining the cost of investment real estate, an insurer should include the cost of personal property necessary to the income generating operations of the investment property. Furniture, fixtures, and equipment so capitalized should be depreciated over their useful lives.

Real estate acquired in satisfaction of debt includes property acquired through foreclosure and through voluntary conveyance.

The cost of real estate acquired through foreclosure or voluntary conveyance is recorded at the lower of fair market value at acquisition or cost. Cost includes the outstanding principal balance of the mortgage loan at the date of foreclosure or conveyance plus foreclosure costs, real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and to place the property in good repair. Uncollected interest or unrecovered advances made before foreclosure should also be included in cost.

Book Value

For real estate that is occupied by the company and for investment real estate, book value would be the cost or other basic value, stated net of any encumbrance, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt and may also include accrued costs of acquisition or construction.

The book value of real estate sold under contract of sale is the balance resulting from the cost of the property, less reductions for cash received on account and for any purchase money mortgage that may have been accepted.
Market Value

Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus.

Appraised Value

An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are used:

1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary adjustments for any difference in the properties.

2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)

3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income.

In most appraisals, all three approaches ordinarily will have something to contribute. Each is used independently to reach an estimated value. Then, by applying to each separate value a weight proportionate to its merits in that particular instance, a conclusion is reached concerning one appropriate value. This procedure is known as correlation.

Statement Value

The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Generally, the value of investment real estate and property acquired in satisfaction of debt may not exceed the lower of current market value or cost plus capitalized improvements, less normal depreciation. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a liability.

Income Derived from Real Estate

Income on real estate, or on space in buildings owned and occupied by the company, usually is received periodically and in advance and any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a period specified by statute or regulation, most jurisdictions require that the entire amount be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part should be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received should be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the rental income for the period.

In the statutory financial statement, a company must include in both its income and expenses an amount for rent relating to its occupancy of its own buildings.
This amount can be the estimated current market rental value of the space involved, or it can be the amount derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the book value of the company's investment in its home office building. The figure thus determined, being both charged to expenses and credited to income, has no effect either on the company's overall net income or surplus.

Sale of Real Estate

A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

Depreciation and Amortization

The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.

A variety of depreciation methods is available and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method, and accelerated methods, such as sum-of-the-years digits and various declining balance methods.

Because real estate leasehold improvements revert to the lessor at the end of the lease and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

Expenses and Capital Improvements

Repairs and maintenance expenditures may be classified as ordinary or extraordinary. As a general rule, expenditures for ordinary repairs that are necessary to put assets back into good operating condition, and for maintenance to keep them that way, are expensed as they are incurred.

Extraordinary expenditures which add to or prolong the life of the property should be capitalized. In practice, most organizations establish a minimum capitalization amount. Individual expenditures below this minimum are expensed rather than capitalized to avoid capitalization of immaterial amounts. Other expenses in operating real estate are expensed as incurred.
Other Real Estate Taxes

Except for the development phase of a project, real and personal property taxes are charged against income. Real and personal property taxes are based upon the assessed valuation of property, as of a given date, as determined by the laws of a state or other taxing authority. The proper accounting treatment must determine when the liability for real and personal property taxes should be accrued. Consistency of application from year to year in establishing this liability is the most important consideration.

The preferred basis for determining the liability and charges for real and personal property taxes should be established at the time of purchase. A practical aspect of the legal liability for these taxes must be considered when title to property is transferred during the taxable year, whereby the date of personal obligation generally controls. Adjustments for property taxes paid or accrued are frequently incorporated in agreements covering the sale of the real estate and determined between the buyer's and seller's obligations. Once established, this liability can be applied consistently throughout the ownership of the property.


22. The Accounting Practice and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22, General Expenses and Taxes, Licenses and Fees, includes the following guidance:

11. Real estate expenses include all costs except salaries and wages of company employees that relate to real estate, whether occupied by the company or not.

23. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19, Expenses, contains the following pertinent excerpts:

3. Taxes, Licenses, and Fees

These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

24. Minnesota state regulations include the following specific guidelines related to valuation of real estate investments:

60A.122 Mortgage and real estate valuation

An insurer shall establish written procedures, approved by the company’s board of directors, for the valuation of commercial mortgage loans and real estate owned. The procedures must be made available to the commissioner upon request. The commissioner shall review the insurer’s compliance with the procedures in any examination of the insurer under section 60A.031.

60A.123 Valuation of foreclosures; reserves

Subdivision 1. Requirement. An insurer shall value its commercial mortgage loans and real estate acquired through foreclosure of commercial mortgage loans as provided in this section for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes.
Subdivision 2. Performing mortgage loan. A performing mortgage loan must be carried at its amortized cost.

Subdivision 3. Distressed mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of its commercial mortgage loans which it classifies as distressed mortgage loans. The carrying value must be based upon one or more of the following procedures:

(1) an internal appraisal;

(2) an appraisal made by an independent appraiser;

(3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer may determine the carrying value of its distressed mortgage loans through either an evaluation of each specific distressed mortgage loan or by a sampling methodology. Insurers using a sampling methodology shall identify a sampling of its distressed mortgage loans that represents a cross section of all of its distressed mortgage loans. The insurer shall make an evaluation of the appropriate carrying value for each sample loan. The carrying value of all of the insurer's distressed mortgage loans must be the same percentage of their amortized acquisition cost as the sample loans. The carrying value must be based upon an internal appraisal or an appraisal conducted by an independent appraiser.

(c) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its distressed mortgage loans.

Subdivision 4. Delinquent mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of each delinquent mortgage loan. The carrying value must be based upon one or more of the following procedures:

(1) an internal appraisal;

(2) an appraisal by an independent appraiser;

(3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its delinquent mortgage loans.

Subdivision 5. Restructured mortgage loan.

(a) The insurer shall make an evaluation of the appropriate carrying value of each restructured mortgage loan. The carrying value must be based upon one or more of the following procedures:

(1) an internal appraisal;

(2) an appraisal by an independent appraiser;

(3) the value of guarantees or other credit enhancements related to the loan.

(b) The insurer shall either take a charge against its surplus or establish a reserve for the difference between the carrying value and the amortized acquisition cost of its restructured mortgage loans.

(a) The insurer shall make an evaluation of the appropriate carrying value of each mortgage loan in foreclosure. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of its mortgage loans in the process of foreclosure.

Subdivision 7. Real estate owned.

(a) The insurer shall make an evaluation of the appropriate carrying value of real estate owned. The carrying value must be based upon an appraisal made by an independent appraiser.

(b) The insurer shall take a charge against its surplus for the difference between the carrying value and the amortized acquisition cost of real estate owned.

60A.125 Property and mortgage loan appraisal

Subdivision 1. Mortgage loans in the process of foreclosure. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of mortgage loans in the process of foreclosure only if the date of the appraisal is within six months of the date the foreclosure procedure is begun. If no appraisal exists, the insurer shall acquire an appraisal within six months after the foreclosure proceeding has begun.

Subdivision 2. Real estate owned. An insurer may rely upon an appraisal by an independent appraiser to determine the carrying value of real estate owned only if the date of the appraisal is within six months of the date when title to the property was acquired. If no appraisal exists, the insurer shall acquire an appraisal within six months after title to the property is acquired.

Subdivision 3. Charge taken. An insurer shall take a charge against the surplus for mortgage loans in the process of foreclosure and real estate owned in the first calendar year in which it holds a current appraisal made by an independent appraiser as provided in this section.

Missouri state regulations also include specific guidelines related to valuation of real estate investments:

20 CSR 200-13.100 Appraisal requirements

Purpose: This rule upgrades the quality of real estate appraisals used by insurers by requiring appraisals meet the same standards as those applicable to federally-regulated financial institutions. This rule effectuates or aids in the interpretation of sections 375.330, 376.300 and 379.080, RSMo.

Editor's Note: The secretary of state has determined that the publication of this rule in its entirety would be unduly cumbersome or expensive. The entire text of the material referenced has been filed with the secretary of state. This material may be found at the Office of the Secretary of State or at the headquarters of the agency and is available to any interested person at a cost established by state law.

(1) Any real estate held as an investment for the production of income pursuant to section 375.330.1(7), RSMo, or any mortgage loan made pursuant to section 376.300.1(9) or 379.080.1(2)(f), RSMo, excluding purchase money mortgages as identified in section 376.300.1(9), RSMo, may be held as an admissible asset only if the appraisal --

(A) Is made of real estate no more than one hundred twenty (120) days before the date the deed or mortgage is recorded in the appropriate public records;
(B) Is a written statement that is independently and impartially prepared by a licensed or certified appraiser setting forth an opinion of defined value of an adequately described property as of a specific date, supported by presentation and analysis of relevant market information;

(C) Provides the current market value of the real estate, that is the value of the real estate in an arms-length sale as of the date of the appraisal; and

(D) Is made by an individual who is --

1. On the national registry of state-certified and licensed appraisers who are eligible to perform appraisals in federally related transactions, which national registry is maintained pursuant to United States P.L. 101-73, Title XI, Section 1103 (12 USC Section 3332); and

2. Certified or licensed to make the appraisal by the state in which the real estate is located.

(2) Notwithstanding any provision of section (1) of this rule to the contrary, no appraisal is necessary in order to admit as an asset the holding of any debt or security issued, assumed or guaranteed by the United States, any state, territory or possession of the United States, the District of Columbia or any administration, agency, authority or instrumentality of them, but only to the extent that the debt or security is issued, assumed insured or guaranteed by any such entity.

(3) Notwithstanding any provision of section (1) of this rule to the contrary, an insurer may establish written procedures, approved by the company's board of directors, for the valuation of its real estate and mortgage loans, which shall exempt the insurer from all of the provisions of section (1). The written procedures must be approved by the director. The director may review the insurer's compliance with these procedures. The director must be notified of any material changes to the written procedures. To be exempt under this section, an insurer's mortgage loan and real estate operations shall meet the following minimum standards:

(A) The insurer shall hold a combined mortgage loan and real estate portfolio valued at three hundred (300) million dollars or more;

(B) The insurer shall establish written procedures and obtain board approval and approval by the director within one hundred twenty (120) days (August 6, 1993) of the effective date of this rule (April 8, 1993);

(C) The insurer, as part of the written procedures, shall establish a reasonable system of valuation of its mortgage loans and real estate which includes the following elements:

1. A system to value its real estate acquired through foreclosure for the purpose of establishing reserves or carrying values of the investments and for statutory accounting purposes;

2. A program for the training, education and certification of employees, at least one (1) of whom must be certified as described in paragraph (1)(D)1. of this rule, who conducts internal appraisals of investments, or a system involving the use of independent certified appraisers as described in paragraph (1)(D)1. of this rule. Any internal appraiser shall not be compensated, directly or indirectly, on the basis of the outcome of appraisals performed and shall have direct reporting access to the chief investment officer of the insurer; and

3. Carrying values for the foreclosed real estate shall be based upon the internal appraisal or an independent appraisal and the value of the guarantees or other credit enhancements related to the investment; and
(D) The audit report of the independent certified public accountant which prepares the audit of the insurer's annual statement shall contain findings by the auditor that --

1. The insurer has adopted valuation procedures meeting the requirements of section (3) of this rule;

2. The procedures adopted by the board of directors have been uniformly applied by the insurer in conformance with section (3) of this rule; and

3. The management of the insurer has an adequate system of internal controls.

26. Nevada Statutes - Insurance Laws, TITLE 57 --- INSURANCE - Chapter 681B - ASSETS AND LIABILITIES provides the following guidance on real estate valuation:

681B.180 Real property

1. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the commissioner to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract plus interest due and accrued at the date of such acquisition, together with any taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.

2. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than 3 years old, the commissioner may, at his discretion, call for and require a new appraisal in order to determine fair value.

27. Arizona Statutes - Insurance Laws, TITLE 20-- INSURANCE, Chapter 3 FINANCIAL PROVISIONS AND PROCEDURES, Article 1. Assets and Liabilities provides similar guidance:

20-513 Real and personal property valuation

A. Real property acquired pursuant to a mortgage loan or contract for sale, in the absence of a recent appraisal deemed by the director to be reliable, shall not be valued at an amount greater than the unpaid principal of the defaulted loan or contract at the date of such acquisition, together with taxes and expenses paid or incurred in connection with such acquisition, and the cost of improvements thereafter made by the insurer and any amounts thereafter paid by the insurer on assessments levied for improvements in connection with the property.

B. Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than three years old, the director may at his discretion call for and require a new appraisal in order to determine fair value.

C. Personal property acquired pursuant to chattel mortgages made in accordance with section 20-555 shall not be valued at an amount greater than the unpaid balance of principal on the defaulted loan at the date of acquisition, together with taxes and expenses incurred in connection with the acquisition, or the fair value of the property, whichever amount is the lesser.

Generally Accepted Accounting Principles

28. FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, provides the following guidance:
48. Real estate investments shall be reported at cost less accumulated depreciation and an allowance for any impairment in value. Depreciation and other related charges or credits shall be charged or credited to investment income. Changes in the allowance for any impairment in value relating to real estate investments shall be included in realized gains and losses.

29. FASB Statement No. 66, *Accounting for Sales of Real Estate*, provides the following guidance:

**INTRODUCTION**

1. This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller's business. The Statement distinguishes between retail land sales and other sales of real estate because differences in terms of sales and selling procedures lead to different profit recognition criteria and methods. Accounting for real estate sales transactions that are not retail land sales is specified in paragraphs 3-43. Accounting for retail land sales transactions is specified in paragraphs 44-50. This Statement does not cover exchanges of real estate for other real estate, the accounting for which is covered in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*.

2. Although this Statement applies to all sales of real estate, many of the extensive provisions were developed over several years to deal with complex transactions that are frequently encountered in enterprises that specialize in real estate transactions. The decision trees on pages 75-79 highlight the major provisions of the Statement and will help a user of the Statement identify criteria that determine when and how profit is recognized. Those using this Statement to determine the accounting for relatively simple real estate sales transactions will need to apply only limited portions of the Statement. The general requirements for recognizing all of the profit on a nonretail land sale at the date of sale are set forth in paragraphs 3-5 and are highlighted on the decision tree on page 75. Paragraphs 6-18 elaborate on those general provisions. Paragraphs 19-43 provide more detailed guidance for a variety of more complex transactions.

**STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

Real Estate Sales Other Than Retail Land Sales

Recognition of Profit by the Full Accrual Method

3. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Recognition of all of the profit at the time of sale or at some later date when both conditions exist is referred to as the full accrual method in this Statement.

4. In accounting for sales of real estate, collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

5. Profit on real estate sales transactions\(^1\) shall not be recognized by the full accrual method until all of the following criteria are met:

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\(^1\) Profit on a sale of a partial interest in real estate shall be subject to the same criteria for profit recognition as a sale of a whole interest.
a. A sale is consummated (paragraph 6).

b. The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property (paragraphs 8-16).

c. The seller's receivable is not subject to future subordination (paragraph 17).

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property (paragraph 18).

Paragraphs 19-43 describe appropriate accounting if the above criteria are not met.

Consummation of a Sale

6. A sale shall not be considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, and (d) all conditions precedent to closing have been performed. Usually, those four conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a preclosing.

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2 Paragraph 20 provides an exception to this requirement if the seller is constructing office buildings, condominiums, shopping centers, or similar structures.

Buyer's Initial and Continuing Investment

7. "Sales value" shall be determined by:

a. Adding to the stated sales price the proceeds from the issuance of a real estate option that is exercised and other payments that are in substance additional sales proceeds. These nominally may be management fees, points, or prepaid interest or fees that are required to be maintained in an advance status and applied against the amounts due to the seller at a later date.

b. Subtracting from the sale price a discount to reduce the receivable to its present value and by the net present value of services that the seller commits to perform without compensation or by the net present value of the services in excess of the compensation that will be received. Paragraph 31 specifies appropriate accounting if services are to be provided by the seller without compensation or at less than prevailing rates.

8. Adequacy of a buyer's initial investment shall be measured by (a) its composition (paragraphs 9-10) and (b) its size compared with the sales value of the property (paragraph 11).

9. The buyer's initial investment shall include only: (a) cash paid as a down payment, (b) the buyer's notes supported by irrevocable letters of credit from an independent established lending institution,3 (c) payments by the buyer to third parties to reduce existing indebtedness on the property, and (d) other amounts paid by the buyer that are part of the sales value. Other consideration received by the seller, including other notes of the buyer, shall be included as part of the buyer's initial investment only when that consideration is sold or otherwise converted to cash without recourse to the seller.

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3 An "independent established lending institution" is an unrelated institution such as a commercial bank unaffiliated with the seller.

10. The initial investment shall not include:
a. Payments by the buyer to third parties for improvements to the property

b. A permanent loan commitment by an independent third party to replace a loan made by the seller

c. Any funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer

4 As an example, if unimproved land is sold for $100,000, with a down payment of $50,000 in cash, and the seller plans to loan the buyer $35,000 at some future date, the initial investment is $50,000 minus $35,000, or $15,000.

11. The buyer's initial investment shall be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable. Lending practices of independent established lending institutions provide a reasonable basis for assessing the collectibility of receivables from buyers of real estate. Therefore, to qualify, the initial investment shall be equal to at least a major part of the difference between usual loan limits and the sales value of the property. Guidance on minimum initial investments in various types of real estate is provided in paragraphs 53 and 54.

12. The buyer's continuing investment in a real estate transaction shall not qualify unless the buyer is contractually required to pay each year on its total debt for the purchase price of the property an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than (a) 20 years for debt for land and (b) the customary amortization term of a first mortgage loan by an independent established lending institution for other real estate. For this purpose, contractually required payments by the buyer on its debt shall be in the forms specified in paragraph 9 as acceptable for an initial investment. Except as indicated in the following sentence, funds to be provided directly or indirectly by the seller (paragraph 10(c)) shall be subtracted from the buyer's contractually required payments in determining whether the initial and continuing investments are adequate. If a future loan on normal terms from an established lending institution bears a fair market interest rate and the proceeds of the loan are conditional on use for specified development of or construction on the property, the loan need not be subtracted in determining the buyer's investment.

Release Provisions

13. An agreement to sell property (usually land) may provide that part or all of the property may be released from liens securing related debt by payment of a release price or that payments by the buyer may be assigned first to released property. If either of those conditions is present, a buyer's initial investment shall be sufficient both to pay release prices on property released at the date of sale and to constitute an adequate initial investment on property not released or not subject to release at that time in order to meet the criterion of an adequate initial investment for the property as a whole.

14. If the release conditions described in paragraph 13 are present, the buyer's investment shall be sufficient, after the released property is paid for, to constitute an adequate continuing investment on property not released in order to meet the criterion of an adequate continuing investment for the property as a whole (paragraph 12).

15. If the amounts applied to unreleased portions do not meet the initial and continuing-investment criteria as applied to the sales value of those unreleased portions, profit shall be recognized on each released portion when it meets the criteria in paragraph 5 as if each release were a separate sale.
16. Tests of adequacy of a buyer's initial and continuing investments described in paragraphs 8-15 shall be applied cumulatively when the sale is consummated and annually afterward. If the initial investment exceeds the minimum prescribed, the excess shall be applied toward the required annual increases in the buyer's investment.

Future Subordination

17. The seller's receivable shall not be subject to future subordination. This restriction shall not apply if (a) a receivable is subordinate to a first mortgage on the property existing at the time of sale or (b) a future loan, including an existing permanent loan commitment, is provided for by the terms of the sale and the proceeds of the loan will be applied first to the payment of the seller's receivable.

Continuing Involvement without Transfer of Risks and Rewards

18. If a seller is involved with a property after it is sold in any way that results in retention of substantial risks or rewards of ownership, except as indicated in paragraph 43, the absence-of-continuing-involvement criterion has not been met. Forms of involvement that result in retention of substantial risks or rewards by the seller, and accounting therefore, are described in paragraphs 25-42.

Recognition of Profit When the Full Accrual Method Is Not Appropriate

19. If a real estate sales transaction does not satisfy the criteria in paragraphs 3-18 for recognition of profit by the full accrual method, the transaction shall be accounted for as specified in the following paragraphs.

Sale Not Consummated

20. The deposit method of accounting described in paragraphs 65-67 shall be used until a sale has been consummated (paragraph 6). "Consummation" usually requires that all conditions precedent to closing have been performed, including that the building be certified for occupancy. However, because of the length of the construction period of office buildings, apartments, condominiums, shopping centers, and similar structures, such sales and the related income may be recognized during the process of construction, subject to the criteria in paragraphs 41 and 42, even though a certificate of occupancy, which is a condition precedent to closing, has not been obtained.

21. If the net carrying amount of the property exceeds the sum of the deposit received, the fair value of the unrecorded note receivable, and the debt assumed by the buyer, the seller shall recognize the loss at the date the agreement to sell is signed.\(^5\) If a buyer defaults, or if circumstances after the transaction indicate that it is probable the buyer will default and the property will revert to the seller, the seller shall evaluate whether the circumstances indicate a decline in the value of the property for which an allowance for loss should be provided.

\(^5\) Paragraph 24 of FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, specifies the accounting for an excess of costs over net realizable value for property that has not yet been sold.

Initial or Continuing Investments Do Not Qualify

22. If the buyer's initial investment does not meet the criteria specified in paragraphs 8-11 for recognition of profit by the full accrual method and if recovery of the cost of the property is reasonably assured if the buyer defaults, the installment method described in paragraphs 56-61 shall be used. If recovery of the cost of the property is not reasonably assured if the buyer defaults or if cost has already been recovered and collection of additional amounts is uncertain,
the cost recovery method (described in paragraphs 62-64) or the deposit method (described in paragraphs 65-67) shall be used. The cost recovery method may be used to account for sales of real estate for which the installment method would be appropriate.

23. If the initial investment meets the criteria in paragraphs 8-11 but the continuing investment by the buyer does not meet the criteria in paragraphs 12 and 16, the seller shall recognize profit by the reduced profit method described in paragraphs 68 and 69 at the time of sale if payments by the buyer each year will at least cover both of the following:

a. The interest and principal amortization on the maximum first mortgage loan that could be obtained on the property
b. Interest, at an appropriate rate, on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan

Paragraphs 13 and 14 of APB Opinion No. 21, Interest on Receivables and Payables, provide criteria for selecting an appropriate rate for present-value calculations.

If the criteria specified in this paragraph for use of the reduced profit method are not met, the seller may recognize profit by the installment method (paragraphs 56-61) or the cost recovery method (paragraphs 62-64).

Receivable Subject to Future Subordination

24. If the seller's receivable is subject to future subordination as described in paragraph 17, profit shall be recognized by the cost recovery method (paragraphs 62-64).

Continuing Involvement without Transfer of Risks and Rewards

25. If the seller has some continuing involvement with the property and does not transfer substantially all of the risks and rewards of ownership, profit shall be recognized by a method determined by the nature and extent of the seller's continuing involvement. Generally, profit shall be recognized at the time of sale if the amount of the seller's loss of profit because of continued involvement with the property is limited by the terms of the sales contract. The profit recognized shall be reduced by the maximum exposure to loss. Paragraphs 26-43 describe some common forms of continuing involvement and specify appropriate accounting if those forms of involvement are present. If the seller has some other form of continuing involvement with the property, the transaction shall be accounted for according to the nature of the involvement.

26. The seller has an obligation to repurchase the property, or the terms of the transaction allow the buyer to compel the seller or give an option to the seller to repurchase the property. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

A right of first refusal based on a bona fide offer by a third party ordinarily is not an obligation or an option to repurchase.
27. The seller is a general partner in a limited partnership that acquires an interest in the property sold (or has an extended, noncancelable management contract requiring similar obligations) and holds a receivable from the buyer for a significant portion of the sales price. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement.

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8 For this purpose, a significant receivable is a receivable in excess of 15 percent of the maximum first-lien financing that could be obtained from an independent established lending institution for the property. It would include:

a. A construction loan made or to be made by the seller to the extent that it exceeds the minimum funding commitment for permanent financing from a third party that the seller will not be liable for
b. An all-inclusive or wraparound receivable held by the seller to the extent that it exceeds prior-lien financing for which the seller has no personal liability
c. Other funds provided or to be provided directly or indirectly by the seller to the buyer
d. The present value of a land lease when the seller is the lessor (footnote 15)

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28. The seller guarantees the return of the buyer's investment or a return on that investment for a limited or extended period. For example, the seller guarantees cash flows, subsidies, or net tax benefits. If the seller guarantees return of the buyer's investment or if the seller guarantees a return on the investment for an extended period, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If the guarantee of a return on the investment is for a limited period, the deposit method shall be used until operations of the property cover all operating expenses, debt service, and contractual payments. At that time, profit shall be recognized on the basis of performance of the services required, as illustrated in paragraphs 84-88.

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9 Guarantees by the seller may be limited to a specified period of time.

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29. The seller is required to initiate or support operations or continue to operate the property at its own risk, or may be presumed to have such a risk, for an extended period, for a specified limited period, or until a specified level of operations has been obtained, for example, until rentals of a property are sufficient to cover operating expenses and debt service. If support is required or presumed to be required for an extended period of time, the transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement. If support is required or presumed to be required for a limited time, profit on the sale shall be recognized on the basis of performance of the services required. Performance of those services shall be measured by the costs incurred and to be incurred over the period during which the services are performed. Profit shall begin to be recognized when there is reasonable assurance that future rent receipts will cover operating expenses and debt service including payments due the seller under the terms of the transaction. Reasonable assurance that rentals will be adequate would be indicated by objective information regarding occupancy levels and rental rates in the immediate area. In assessing whether rentals will be adequate to justify recognition of profit, total estimated future rent receipts of the property shall be reduced by one-third as a reasonable safety factor unless the amount so computed is less than the rents to be received from signed leases. In this event, the rents from signed leases shall be substituted for the computed amount. Application of this method is illustrated in paragraphs 84-89.

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10 Support shall be presumed to be required if: (a) a seller obtains an interest as a general partner in a limited partnership that acquires an interest in the property sold; (b) a seller retains an equity interest in the property, such as an undivided interest or an equity interest in a joint venture that holds an interest in the property; (c) a seller holds a receivable from a buyer for a significant part of the sales price and collection of the receivable depends on the operation of the property; or (d) a seller agrees to manage the property for the buyer on terms not usual for the services to be rendered, and the agreement is not terminable by either the seller or the buyer.
30. If the sales contract does not stipulate the period during which the seller is obligated to support operations of the property, support shall be presumed for at least two years from the time of initial rental unless actual rental operations cover operating expenses, debt service, and other contractual commitments before that time. If the seller is contractually obligated for a longer time, profit recognition shall continue on the basis of performance until the obligation expires. Calculation of profits on the basis of performance of services is illustrated in paragraphs 84-89.

31. If the sales contract requires the seller to provide management services relating to the property after the sale without compensation or at compensation less than prevailing rates for the service required (paragraph 7) or on terms not usual for the services to be rendered (footnote 10(d)), compensation shall be imputed when the sale is recognized and shall be recognized in income as the services are performed over the term of the management contract.

32. The transaction is merely an option to purchase the property. For example, undeveloped land may be “sold” under terms that call for a very small initial investment by the buyer (substantially less than the percentages specified in paragraph 54) and postponement of additional payments until the buyer obtains zoning changes or building permits or other contingencies specified in the sales agreement are satisfactorily resolved. Proceeds from the issuance of the option by a property owner shall be accounted for as a deposit (paragraphs 65-67). Profit shall not be recognized until the option either expires or is exercised. When an option to purchase real estate is sold by an option holder, the seller of the option shall recognize income by the cost recovery method (paragraphs 62-64) to the extent nonrefundable cash proceeds exceed the seller’s cost of the option if the buyer’s initial and continuing investments are not adequate for profit recognition by the full accrual method (paragraphs 7-16).

33. The seller has made a partial sale. A sale is a partial sale if the seller retains an equity interest in the property or has an equity interest in the buyer. Profit (the difference between the sales value and the proportionate cost of the partial interest sold) shall be recognized at the date of sale if:

a. The buyer is independent of the seller.

b. Collection of the sales price is reasonably assured (paragraph 4).

c. The seller will not be required to support the operations of the property or its related obligations to an extent greater than its proportionate interest.

34. If the buyer is not independent of the seller, for example, if the seller holds or acquires an equity interest in the buyer, the seller shall recognize the part of the profit proportionate to the outside interests in the buyer at the date of sale. If the seller controls the buyer, no profit on the sale shall be recognized until it is realized from transactions with outside parties through sale or operations of the property.

35. If collection of the sales price is not reasonably assured, the cost recovery or installment method of recognizing profit shall be used.

36. If the seller is required to support the operations of the property after the sale, the accounting shall be based on the nature of the support obligation. For example, the seller may retain an interest in the property sold and the buyer may receive preferences as to profits, cash flows, return on investment, and so forth. If the transaction is in substance a sale, the seller shall recognize profit to the extent that proceeds from the sale, including receivables from the buyer, exceed all of the seller’s costs related to the entire property. Other examples of support obligations are described in paragraphs 29-31.
37. If individual units in condominium projects or time-sharing interests are being sold separately and all the following criteria are met, profit shall be recognized by the percentage-of-completion method on the sale of individual units or interests:

12 A condominium project may be a building, a group of buildings, or a complete project.

a. Construction is beyond a preliminary stage. 13

13 Construction is not beyond a preliminary stage if engineering and design work, execution of construction contracts, site clearance and preparation, excavation, and completion of the building foundation are incomplete.

b. The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest. 14

14 The buyer may be able to require a refund, for example, if a minimum status of completion of the project is required by state law and that status has not been attained; if state law requires that a “Declaration of Condominium” be filed and it has not been filed, except that in some states the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable; if the sales contract provides that permanent financing at an acceptable cost must be available to the buyer at the time of closing and it is not available; or if the condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission, and they are not so registered.

c. Sufficient units have already been sold to assure that the entire property will not revert to rental property. In determining whether this condition has been met, the seller shall consider the requirements of state laws, the condominium or time-sharing contract, and the terms of the financing agreements.

d. Sales prices are collectible (paragraph 4).

e. Aggregate sales proceeds and costs can be reasonably estimated. Consideration shall be given to sales volume, trends of unit prices, demand for the units including seasonal factors, developer's experience, geographical location, and environmental factors.

If any of the above criteria is not met, proceeds shall be accounted for as deposits until the criteria are met.

38. The seller sells property improvements and leases the underlying land to the buyer of the improvements. In these circumstances, the transactions are interdependent and it is impracticable to distinguish between profits on the sale of the improvements and profits under the related lease. The transaction shall be accounted for as a lease of both the land and improvements if the term of the land lease to the buyer from the seller of the improvements either (a) does not cover substantially all of the economic life of the property improvements, thus strongly implying that the transaction is in substance a lease of both land and improvements, or (b) is not for a substantial period, for example, 20 years.
39. If the land lease described in paragraph 38 covers substantially all of the economic life of the improvements and extends for at least 20 years, the profit to be recognized on the sale of the improvements at the time of sale shall be (a) the present value of the rental payments\(^{15}\) not in excess of the seller's cost of the land plus (b) the sales value of the improvements minus (c) the carrying value of the improvements and the land. Profit on (1) the buyer's rental payments on the land in excess of the seller's cost of the land and (2) the rent to be received on the land after the maturity of the primary indebtedness on the improvements or other customary amortization term shall be recognized when the land is sold or the rents in excess of the seller's cost of the land are accrued under the lease. Calculations of profit in those circumstances are illustrated in paragraphs 82 and 83.

\(^{15}\) The present value of the specified rental payments is the present value of the lease payments specified in the lease over the term of the primary indebtedness, if any, on the improvements, or over the customary amortization term of primary debt instruments on the type of improvements involved. The present value is computed at an interest rate appropriate for (a) primary debt if the lease is not subordinated or (b) secondary debt if the lease is subordinated to loans with prior liens.

40. The sale of the property is accompanied by a leaseback to the seller of all or any part of the property for all or part of its remaining economic life. Real estate sale and leaseback transactions shall be accounted for in accordance with the provisions of this Statement and FASB Statements No. 13, Accounting for Leases, and 28, Accounting for Sales with Leasebacks. Statement 13 as amended by Statement 28 provides criteria for determining if a leaseback is a capital lease or an operating lease. If the leaseback is a capital lease, the seller-lessee shall record an asset and an obligation as prescribed by Statement 13. Regardless of whether the leaseback is a capital lease or an operating lease, a sale shall be recorded, and the property sold and any related debt assumed by the buyer shall be removed from the seller-lessee's balance sheet. The criteria in this Statement then shall be used to determine the amount of profit that would be recognized at the date of sale, absent the leaseback provisions. The profit so determined shall be accounted for in accordance with the provisions of Statements 13 and 28 (usually deferred and amortized over the term of the lease) unless other provisions of this Statement require postponement of profit recognition until a later event.

41. The sales contract or an accompanying agreement requires the seller to develop the property in the future, to construct facilities on the land, or to provide off-site improvements or amenities. The seller is involved with future development or construction work if the buyer is unable to pay amounts due for that work or has the right under the terms of the arrangement to defer payment until the work is done. If future costs of development can be reasonably estimated at the time of sale, profit allocable to (a) performance before the sale of the land and (b) the sale of the land shall be recognized when the sale of the land meets the criteria in paragraph 5. Profit allocable to performance after the sale shall be recognized by the percentage-of-completion method as development and construction proceed, provided that cost and profit can be reasonably estimated from the seller's previous experience.

42. The profit shall be allocated to the sale of the land and the later development or construction work on the basis of estimated costs of each activity; the same rate of profit shall be attributed to each activity. No profit shall be recognized at the time of sale if future costs of development cannot be reasonably estimated at that time.
43. The seller will participate in future profit from the property without risk of loss (such as participation in operating profits or residual values without further obligation). If the transaction otherwise qualifies for recognition of profit by the full accrual method, the transfer of risks and rewards of ownership and absence of continuing involvement criterion shall be considered met. The contingent future profits shall be recognized when they are realized.\textsuperscript{16} All the costs of the sale shall be recognized at the time of sale; none shall be deferred to periods when the contingent profits are recognized.

\textsuperscript{16} Paragraph 17 of FASB Statement No. 5, Accounting for Contingencies, addresses accounting for gain contingencies.

Retail Land Sales

44. A single method of recognizing profit shall be applied to all sales transactions within a project\textsuperscript{17} that have been consummated.\textsuperscript{18} That method of recognizing profit shall be changed when certain conditions are met for the entire project (paragraph 49).

\textsuperscript{17} A retail land sales “project” is a homogeneous, reasonably contiguous area of land that may, for development and marketing, be subdivided in accordance with a master plan.

\textsuperscript{18} Retail land sales shall be considered consummated when all of the criteria in paragraph 47 are met.

Recognition of Profit

45. The full accrual method of accounting described in paragraphs 70-72 shall be applied to a sale if all of the following conditions are met:

a. Expiration of refund period. The buyer has made the down payment and each required subsequent payment until the period of cancellation with refund has expired. That period shall be the longest period of those required by local law, established by the seller's policy, or specified in the contract.

b. Sufficient cumulative payments. The cumulative payments of principal and interest equal or exceed 10 percent of the contract sales price.

c. Collectibility of receivables. Collection experience for the project in which the sale is made or for the seller's prior projects indicates that at least 90 percent of the contracts in the project in which the sale is made that are in force 6 months after the criteria in paragraph 46 are met will be collected in full.\textsuperscript{19} The collection experience with the seller's prior projects may be applied to a new project if the prior projects:

\textsuperscript{19} The six-month period is solely a test of eligibility for the accrual method and is not intended to restrict the recognition of profit before the six-month period expires.

(1) Had predominantly the same characteristics (type of land, environment, clientele, contract terms, sales methods)\textsuperscript{20} as the new project.

\textsuperscript{20} Examples of sales methods include telephone sales, broker sales, and site-visitation sales.

(2) Had a sufficiently long collection period to indicate the percentage of current sales of the new project that will be collected to maturity. A down payment of at least 20 percent shall be an acceptable indication of collectibility.
d. Nonsubordination of receivables. The receivable from the sale is not subject to subordination to new loans on the property except that subordination by an individual lot buyer for home construction purposes is permissible if the collection experience on those contracts is the same as on contracts not subordinated.

e. Completion of development. The seller is not obligated to complete improvements of lots sold or to construct amenities or other facilities applicable to lots sold. Paragraphs 6-49 specify accounting methods that shall be used if the above criteria are not met.

46. The percentage-of-completion method of accounting described in paragraphs 73-75 shall be applied to a sale that meets all of the following criteria:

   21 In the AICPA Guide, Accounting for Retail Land Sales, this was called the "accrual method."

a. The period of cancellation with refund has expired (paragraph 45(a)).

b. Cumulative payments equal or exceed 10 percent (paragraph 45(b)).

c. Receivables are collectible (paragraph 45(c)).

d. Receivables are not subject to subordination (paragraph 45(d)).

e. There has been progress on improvements. The project's improvements have progressed beyond preliminary stages, and there are indications that the work will be completed according to plan. Some indications of progress are:

   (1) The expenditure of funds on the proposed improvements.
   (2) Initiation of work on the improvements.
   (3) Existence of engineering plans and work commitments relating to lots sold.
   (4) Completion of access roads and amenities such as golf courses, clubs, and swimming pools.

In addition, there shall be no indication of significant delaying factors, such as the inability to obtain permits, contractors, personnel, or equipment, and estimates of costs to complete and extent of progress toward completion shall be reasonably dependable.

f. Development is practical. There is a reasonable expectation that the land can be developed for the purposes represented and the properties will be useful for those purposes at the end of the normal payment period. For example, it should be expected that legal restrictions, including environmental restrictions, will not seriously hamper development and that improvements such as access roads, water supply, and sewage treatment or removal are feasible within a reasonable time. Paragraphs 47 and 48 specify accounting methods that shall be used if the above criteria are not met.

47. The installment method of accounting described in paragraphs 56-61 shall be applied to a sale that meets all of the following criteria:

a. The period of cancellation with refund has expired (paragraph 45(a)).

b. Cumulative payments equal or exceed 10 percent (paragraph 45(b)).

c. The seller is financially capable. The seller is clearly capable of providing both land improvements and off-site facilities promised in the contract and of meeting all other representations it has made. It is financially capable of funding or bonding the planned improvements in the project when required. That capability may be indicated by the
seller's equity capitalization, its borrowing capacity, or its positive cash flow from operations.

48. If a retail land sale transaction does not meet the criteria for accounting by the methods described in paragraphs 45-47, that transaction shall be accounted for as a deposit as described in paragraphs 65-67.

Change from Installment to Percentage-of-Completion Method

49. When all of the conditions in paragraph 46 are satisfied on a retail land sales project originally reported by the installment method, the percentage-of-completion method of accounting may be adopted for the entire project (current and prior sales) and the effect accounted for as a change in accounting estimate.22

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22 The credit to income resulting from the change is the profit not yet recognized less (a) a discount, if required, to reduce the receivable balances to their present values at the date of change to the percentage-of-completion method (using the appropriate interest rates, as specified in paragraphs 13 and 14 of Opinion 21, in effect at the time of the original sales) and (b) the liability (also discounted) for remaining future performance. The computation is illustrated in paragraph 97.

Financial Statement Presentation and Disclosures

50. In addition to disclosures otherwise required by generally accepted accounting principles, the financial statements of enterprises with retail land sales operations shall disclose:

a. Maturities of accounts receivable for each of the five years following the date of the financial statements
b. Delinquent accounts receivable and the method(s) for determining delinquency
c. The weighted average and range of stated interest rates of receivables
d. Estimated total costs and estimated dates of expenditures for improvements for major areas from which sales are being made over each of the five years following the date of the financial statements
e. Recorded obligations for improvements

Financial statement presentations of retail land sales transactions are illustrated in paragraphs 95-97.

Amendments to Other Pronouncements

51. The references to the AICPA Industry Accounting Guides, Accounting for Profit Recognition on Sales of Real Estate and Accounting for Retail Land Sales, and the AICPA Statements of Position (SOPs) 75-6, Questions Concerning Profit Recognition on Sales of Real Estate and 78-4, Application of the Deposit, Installment, and Cost Recovery Methods in Accounting for Sales of Real Estate, are deleted from Appendix A of FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters. The references to the profit recognition Guide in paragraph 7 of FASB Statement No. 26, Profit Recognition on Sales-Type Leases of Real Estate, and in footnote *** and paragraphs 23-25 of Statement 28 are amended to refer to Statement No. 66, Accounting for Sales of Real Estate.

Effective Date and Transition

52. This Statement shall be applied to real estate sales transactions entered into after December 31, 1982 and to changes in methods of accounting for real estate sales transactions made after that date. Earlier application is encouraged but not required. The disclosures required by paragraph 50 shall be provided in financial statements for periods ending after December 15, 1982.
Appendix A:
MINIMUM INITIAL INVESTMENTS

53. Minimum initial investment requirements for sales, other than retail land sales, that are to be accounted for by the full accrual method are specified in paragraph 11. The table of minimum initial investments in paragraph 54 is based on usual loan limits for various types of properties. However, lenders’ appraisals of specific properties may differ. Therefore, if a recently placed permanent loan or firm permanent loan commitment for maximum financing of the property exists with an independent established lending institution, the minimum initial investment should be whichever of the following is greater:

a. The minimum percentage of the sales value (paragraph 7) of the property specified in paragraph 54

b. The lesser of:
   
   (1) The amount of the sales value of the property in excess of 115 percent of the amount of a newly placed permanent loan or firm permanent loan commitment from a primary lender that is an independent established lending institution
   
   (2) Twenty-five percent of the sales value

54. This table does not cover every type of real estate property. To evaluate initial investments on other types of property, enterprises may make analogies to the types of properties specified, or the risks of a particular property can be related to the risks of the properties specified. Use of this table is illustrated in paragraphs 77-83.

<table>
<thead>
<tr>
<th>Minimum Initial Investment Expressed as a Percentage of Sales Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
</tr>
<tr>
<td>Held for commercial, industrial, or residential</td>
</tr>
<tr>
<td>development to commence within two years after sale</td>
</tr>
<tr>
<td>Held for commercial, industrial, or residential</td>
</tr>
<tr>
<td>development to commence after two years</td>
</tr>
<tr>
<td>Commercial and Industrial Property</td>
</tr>
<tr>
<td>Office and industrial buildings, shopping centers, and so forth:</td>
</tr>
<tr>
<td>Properties subject to lease on a long-term lease basis</td>
</tr>
<tr>
<td>to parties with satisfactory credit rating; cash flow</td>
</tr>
<tr>
<td>currently sufficient to service all indebtedness</td>
</tr>
<tr>
<td>Single-tenancy properties sold to a buyer with a</td>
</tr>
<tr>
<td>satisfactory credit rating</td>
</tr>
<tr>
<td>All other</td>
</tr>
<tr>
<td>Other income-producing properties (hotels, motels, marinas,</td>
</tr>
<tr>
<td>mobile home parks, and so forth):</td>
</tr>
<tr>
<td>Cash flow currently sufficient to service all indebtedness</td>
</tr>
<tr>
<td>Start-up situations or current deficiencies in cash flow</td>
</tr>
<tr>
<td>Multifamily Residential Property</td>
</tr>
<tr>
<td>Primary residence:</td>
</tr>
<tr>
<td>Cash flow currently sufficient to service all indebtedness</td>
</tr>
<tr>
<td>Start-up situations or current deficiencies in cash flow</td>
</tr>
</tbody>
</table>
Secondary or recreational residence:
Cash flow currently sufficient to service all indebtedness 15
Start-up situations or current deficiencies in cash flow 25

Single-Family Residential Property (including condominium or cooperative housing)
Primary residence of the buyer 5
Secondary or recreational residence 10

---
a If collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience, the minimum initial investment shall be at least 60 percent of the difference between the sales value and the financing available from loans guaranteed by regulatory bodies such as the Federal Housing Authority (FHA) or the Veterans Administration (VA), or from independent, established lending institutions. This 60-percent test applies when the independent first-mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the initial investment. If independent first mortgage financing is utilized, the adequacy of the initial investment on sales of single-family residential property should be determined in accordance with paragraph 53.

Appendix B:
DESCRIPTION OF CERTAIN METHODS OF ACCOUNTING FOR REAL ESTATE SALES TRANSACTIONS
55. This appendix describes several of the methods of profit recognition that are provided for by this Statement.

Installment Method

56. The installment method apportions each cash receipt and principal payment by the buyer on debt assumed between cost recovered and profit. The apportionment is in the same ratio as total cost and total profit bear to the sales value. The calculation is illustrated in paragraph 90.

57. If the stated interest rate is equal to or less than an appropriate interest rate, it is acceptable not to reduce the receivable to its present value. This ordinarily results in reducing profit recognized in the earlier years.

58. Under the installment method, the receivable less profits not recognized does not exceed what the property value would have been if the property had not been sold.

59. The income statement, or related footnotes, for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Revenue and cost of sales (or gross profit) are presented as separate items on the income statement or are disclosed in the footnotes when profit is recognized as earned. This presentation is illustrated in paragraph 96.

60. Paragraph 75 describes accounting for obligations for future improvement costs under the percentage-of-completion method. That description applies as well to accounting for those obligations under the installment method.

61. If after adoption of the installment method the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18) of recognizing profit for real estate sales other than retail land sales, the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.
Cost Recovery Method

62. Under the cost recovery method, no profit is recognized until cash payments by the buyer, including principal and interest on debt due to the seller and on existing debt assumed by the buyer, exceed the seller's cost of the property sold. The receivable less profits not recognized, if any, does not exceed what the depreciated property value would have been if the property had not been sold.

23 For an all-inclusive or “wrap-around” receivable held by the seller, interest collected is recognized as income to the extent of, and as an appropriate offset to, interest expense on prior-lien financing for which the seller remains responsible.

63. The income statement for the period including the date of sale presents the sales value, the gross profit that has not yet been recognized, and the total cost of the sale. Gross profit not yet recognized is offset against the related receivable on the balance sheet. Principal collections reduce the related receivable, and interest collections on such receivables increase the unrecognized gross profit on the balance sheet. Gross profit is presented as a separate item of revenue on the income statement when it is recognized as earned.

64. If, after the adoption of the cost recovery method, the transaction meets the requirements for the full accrual method (specified in paragraphs 3-18), the seller may then change to the full accrual method. The remaining profit that was not recognized is recognized in income at that time.

Deposit Method

65. Under the deposit method, the seller does not recognize any profit, does not record notes receivable, continues to report in its financial statements the property and the related existing debt even if it has been assumed by the buyer, and discloses that those items are subject to a sales contract. The seller continues to charge depreciation to expense as a period cost for the property for which deposits have been received. Cash received from the buyer, including the initial investment and subsequent collections of principal and interest, is reported as a deposit on the contract except that, for sales that are not retail land sales, portions of cash received that are designated by the contract as interest and are not subject to refund offset carrying charges (property taxes and interest on existing debt) on the property. Interest collected that is subject to refund and is included in the deposit account before a sale is consummated is accounted for as part of the buyer's initial investment (paragraph 7) at the time the sale is consummated.

66. When a contract is canceled without a refund, deposits forfeited are recognized as income. When deposits on retail land sales are ultimately recognized as sales, the interest portion is recognized as interest income.

67. The seller's balance sheet presents nonrecourse debt assumed by the buyer among the liabilities; the debt assumed is not offset against the related property. The seller reports the buyer's principal payments on mortgage debt assumed as additional deposits with corresponding reductions of the carrying amount of the mortgage debt.
Reduced-Profit Method

68. A reduced profit is determined by discounting the receivable from the buyer to the present value of the lowest level of annual payments required by the sales contract over the maximum period specified in paragraph 12 and excluding requirements to pay lump sums. The present value is calculated using an appropriate interest rate, but not less than the rate stated in the sales contract. This method permits profit to be recognized from level payments on the buyer's debt over the maximum term established in paragraph 12 and postpones recognition of other profits until lump sum or other payments are made.

24 Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.

69. To illustrate, assume a sale of land that cost the seller $800,000 and is being sold for $1,000,000 with the following financing:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyer's initial investment</td>
<td>$250,000</td>
</tr>
<tr>
<td>First mortgage note payable to an independent lending institution</td>
<td>$500,000</td>
</tr>
<tr>
<td>Second mortgage note payable to seller</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total selling price</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

The amortization term of the second mortgage (25 years) exceeds the term permitted by paragraph 12 (20 years for sales of land). It is assumed that the payments by the buyer each year will meet the requirement in paragraph 23, that the reduced-profit method is to be applied, and that the market interest rate is 16 percent.

The present value of $31,875 per year for 20 years at a market rate of 16 percent is $31,875 x 5.92884 = $188,982.

The profit to be recognized at the time of sale is reduced by the difference between the face amount of the seller's receivable ($250,000) and the reduced amount ($188,982), or $61,018. The profit recognized at the time of sale is $1,000,000 (sales price) minus $800,000 (cost) minus $61,018, or $138,982. Additional profit of $61,018 is recognized as the second mortgage payments are received in years 21 through 25.

Full Accrual Method--Retail Land Sales

70. Revenues and costs are accounted for under the accrual method as follows:

a. The net receivable is discounted to the present value of the payments required. The present value is determined using an appropriate interest rate, but not less than the rate stated in the sales contract. The objective is to value the net receivable at the amount at which it could be sold without recourse to the seller at the date of the sales contract.

25 Paragraphs 13 and 14 of Opinion 21 provide criteria for selecting an appropriate rate for present value calculations.
b. An allowance is provided for receivables that are not expected to be collected because of cancellation in subsequent periods. Receivable balances applicable to canceled contracts are charged in their entirety to the allowance for contract cancellations when those contracts are canceled.

c. Costs of sales (land and improvement costs incurred, carrying costs, and so forth) are based on sales net of those sales expected to be canceled in future periods.

71. Historical data is evaluated to predict the collection of receivables from current sales. The historical data is selected from a representative sample of receivables that reflect the latest available collection data and cover an adequate period of time. The receivables in the sample are considered uncollectible and the allowance for contract cancellations provided for previously recognized sales (paragraph 70(b)) is appropriately adjusted if payments due are unpaid at the end of the sample period selected for the following delinquency periods:

<table>
<thead>
<tr>
<th>Percent of Contract Price Paid</th>
<th>Delinquency Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 25 percent</td>
<td>90 days</td>
</tr>
<tr>
<td>25 percent but less than 50 percent</td>
<td>120 days</td>
</tr>
<tr>
<td>50 percent and over</td>
<td>150 days</td>
</tr>
</tbody>
</table>

The specified delinquency periods may be extended if the seller’s recent experience has been better or if the buyer has accepted, or is willing to accept, personal liability on its debt, provided that the buyer’s ability to complete payment on the contract can be determined.

72. Many sellers have programs to accelerate collections of receivables or contract provisions that encourage prepayment with a reduction of the principal as the major incentive for prepayment. If a seller expects to institute those or similar programs in the future, the amount of profit recognized at the date of sale is reduced through charges to income for anticipated discounts not otherwise recognized. Reductions that are given sporadically are charged to income in the period they occur.

Percentage-of-Completion Method--Retail Land Sales

73. The earnings process is not complete if a seller is obliged to complete improvements of lots sold or to construct amenities and other facilities applicable to lots sold, if those obligations are significant in relation to total costs, and if they remain unperformed at the time the sale is recognized. Therefore, the amount of revenue recognized (the discounted contract price) at the time a sale is recognized is measured by the relationship of costs already incurred to total estimated costs to be incurred, including costs of the marketing effort. If performance is incomplete, the portion of revenue related to costs not yet incurred is recognized as the costs are incurred.

26 Performance means completion of the improvements required under the sales contract by either the seller or contractors retained by the seller. However, payments made to municipalities or other governmental organizations not under the direct or joint control of the seller constitute performance by the seller if those organizations are not financed solely by liens on property in the project and they undertake to complete the improvements without further risk or obligation of the seller.

74. The costs already incurred and total costs to be incurred include land cost, costs previously charged to expense, such as interest and project carrying costs incurred prior to sale, and selling costs directly associated with a project. The accounting described in this paragraph and paragraph 73 is illustrated in paragraphs 91-95.

27 Accounting for selling costs is addressed in FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects.

75. If there is an obligation for future improvement costs that is recognized under the percentage-of-completion method:
a. Estimates are based on costs generally expected in the construction industry locally.
b. Unrecoverable costs of off-site improvements, utilities, and amenities are provided for. In determining the amount of unrecoverable costs, estimates of amounts to be recovered from future sale of the improvements, utilities, and amenities are discounted to present value as of the date the net unrecoverable costs are recognized.

76. Estimates of future improvement costs are reviewed at least annually. Changes in those estimates do not lead to adjustment of revenue applicable to future improvements that has been previously recorded unless the adjusted total estimated cost exceeds the applicable revenue. When cost estimates are revised, the relationship of the two elements included in the revenue not yet recognized—costs and profit—is recalculated on a cumulative basis to determine future income recognition as performance takes place. If the adjusted total estimated cost exceeds the applicable revenue previously recognized, the total anticipated loss is charged to income when it meets the criteria in paragraph 8 of Statement 5. When anticipated losses on lots sold are recognized, the enterprise also considers recognizing a loss on land and improvements not yet sold.

Appendix C:
ILLUSTRATIONS OF CALCULATIONS FOR RECOGNITION OF PROFIT ON SALES OF REAL ESTATE OTHER THAN RETAIL LAND SALES

The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

Exhibits

<table>
<thead>
<tr>
<th>Paragraph Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Illustration of Effect of Land Lease--New Multifamily Residential Property</td>
</tr>
<tr>
<td>II. Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller</td>
</tr>
<tr>
<td>Schedule A: Example of Profit Calculation (assuming actual rental revenue equals adjusted projection)</td>
</tr>
<tr>
<td>Schedule B: Example of Profit Calculation (assuming actual rental revenue equals unadjusted projection)</td>
</tr>
<tr>
<td>Schedule C: Calculation of Adjusted Projected Rental Revenue</td>
</tr>
<tr>
<td>III. Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer</td>
</tr>
</tbody>
</table>

Exhibit I--Illustration of Effect of Land Lease--New Multifamily Residential Property

77. Land improvements may be sold and concurrently the land under the improvements may be leased to the buyer of the improvements.

78. This exhibit illustrates the effect of loans issued in connection with long-term land leases on evaluations of the adequacy of a buyer's initial investment if improvements on the land are sold separately. In addition, it demonstrates the limit that a lease places on profit recognition if the leased land is owned by the seller of the improvements, making the lease of land and sale of improvements interdependent transactions.
79. The calculations are illustrated for four different circumstances: two examples with a primary land lease and two with a subordinated land lease.

80. Primary Land Lease: Land Owned by Third Party Lessor--Nonqualifying

Assumptions:

Sales price of improvements $875,000

Represented by proceeds of:

Cash down payment $125,000

Loan by insurance company: lien on leasehold improvements, 28-year term, 8 1/2%, payable in equal monthly installments of principal and interest $657,000

Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest $93,000

$875,000

Land lease for 99 years @ $19,000/year, net, payable monthly in advance

Cost of constructing improvements--$750,000

No continuing involvement by seller

Computations:

Present value of 336 monthly payments on land lease of $1,583.33 discounted at 8 1/2% (interest rate on loan from insurance company): $1,583.33 + ($1,583.33 x 127.9071) $204,000

Loan from insurance company 657,000

Equivalent primary debt 861,000

Note receivable from buyer 93,000

Total debt or equivalent 954,000

Down payment 125,000

Sales value $1,079,000

Because 15% of the sales value of the improvements is $161,850, the initial investment of $125,000 (about 12% of adjusted sales value) is inadequate to recognize profit on the sale of improvements. The second test is therefore irrelevant.
81. Primary Land Lease: Land Owned by Third Party Lessor--Qualifying

Assumptions:

Sales price of improvements $875,000

Represented by proceeds of:

Cash down payment $165,000

Loan by insurance company: lien on leasehold improvements, 28-year term, 8 1/2%, payable in equal monthly installments of principal and interest 657,000

Note received by seller from buyer: 12-year term, 9 1/2%, payable in equal monthly installments of principal and interest 53,000

$875,000

Land lease for 99 years @ $17,880/year, net, payable monthly in advance

Cost of constructing improvements--$750,000

No continuing involvement by seller

Computations:

Present value of 336 monthly payments on land lease of $1,490 discounted at 8 1/2% (interest rate on loan from insurance company): $1,490 + ($1,490 x 127.9071) $192,000

Loan from insurance company 657,000

Equivalent primary debt 849,000

Note receivable from buyer 53,000

Total debt or equivalent 902,000

Down payment 165,000

Sales value $1,067,000

Because 15% of the sales value of the improvements is $160,050, the initial investment of $165,000 (15% of the sales value) is adequate to recognize profit on the sale of improvements. However, the second test must also be applied.

The initial investment required by the second test is:

Sales value $1,067,000

115% of $849,000 (loan from primary lender) 976,350

$90,650

The initial investment of $165,000 exceeds the amount required, so recognition of profit on sale of improvements is appropriate. The second test may alternatively be applied as the ratio of total debt or equivalent to the equivalent primary debt: $902,000/$849,000 = 106%. Because 106% is less than 115%, the initial investment exceeds the difference between the sales value of the property and 115% of the equivalent primary debt.

Profit recognition:

Sales price of improvements $875,000

Less: Cost of improvements 750,000

Profit recognized at time of sale $125,000
82. Subordinated Land Lease: Land Owned by Seller--Qualifying

Assumptions:
Sales price of improvements $ 914,000

Represented by proceeds of:
Cash down payment $ 154,000
Loan by insurance company: first lien on
the fee or on subordinated leasehold, 28-year term, 8 1/4%, payable in equal monthly
installments of principal and interest $ 760,000
$ 914,000

Land lease for 99 years @ $11,580/year, net, payable
monthly in advance, and 5% of gross rents
Cost of land--$200,000
Cost of constructing improvements--$750,000
No continuing involvement by seller

Computations:
Present value of 336 monthly payments on land lease
at $965 discounted at 12% (imputed interest for
a second lien receivable): $965 + ($965 x 96.432696) $ 94,000
Loan from insurance company (primary debt
Total debt or equivalent 854,000
Down payment
Sales value $1,008,000

The initial investment ($154,000) is more than 15% of
the sales value. (15% x $1,008,000 = $151,200).
The initial investment is also larger than the
excess of the sales value over 115% of the
primary debt.
Sales value $1,008,000
115% of $760,000 874,000
Excess of sales value over 115% of debt $ 134,000

Therefore, the initial investment of $154,000 is adequate, and recognizing profit on the sale of the
improvements is appropriate.

Profit recognition:
Sales value $1,008,000
Less: Cost of improvements $750,000
Cost of land 200,000 $ 950,000
Profit recognized at time of sale $ 58,000

The effect of including the present value of the lease is to reduce profit recognized by $106,000:
$94,000 (present value of the land lease) - $200,000 (cost of land).
83. Subordinated Land Lease: Land Owned by Seller--Nonqualifying

Assumptions:
Sales price of improvements $875,000

Represented by proceeds of:
   Cash down payment $132,000
   Loan by insurance company: first lien on the fee
   or on subordinated leasehold, 28-year term, 8 1/4%,
   payable in equal monthly installments of principal
   and interest 743,000

$875,000

Land lease for 99 years @ $19,332/year, net, payable
monthly in advance
Cost of land--$200,000
Cost of improvements--$750,000
No continuing involvement by seller

Computations:
Present value of 336 monthly payments on land lease
of $1,611 discounted at 12% (imputed interest for
a second lien receivable): $1,611 + ($1,611 x
96.432696) $157,000
Loan from insurance company (primary debt) 743,000

Total debt or equivalent 900,000
Down payment 132,000
Sales value 1,032,000

The initial investment ($132,000) is less than 15% of the sales value (15% x $1,032,000 = $154,800), and therefore is inadequate to recognize profit on sale of improvements. Profit recognized at time of sale should not exceed that recognizable under the installment method as if the subordinated lease were an installment receivable.

Profit recognition on installment method:
Sales value 1,032,000
Less: Cost of improvements $750,000
   Cost of land 200,000
   Anticipated profit on sale of improvements $82,000

Cash received or to be received by the seller, other than the proceeds of the primary loan, is:
Down payment 132,000
Present value of land lease payments 157,000
$289,000

The percentage of profit in each collection is therefore:
$82,000
$289,000 = 28.37%
Profit recognizable in the period of sale is 28.37% of the down payment of $132,000, or $37,450. The remaining profit of $44,550 will be recognized at the rate of 28.37% of the portion of each lease payment that is equivalent to a reduction of principal on a loan of $157,000 for 28 years at 12%.

The effect of including the present value of the lease in the sales value of the improvements is to reduce the profit recognized on the improvements by $43,000: $157,000 (present value of the land lease) - $200,000 (cost of the land).

Exhibit II--Illustration of Profit Recognition--Sale of Property with Construction and Support Obligations by Seller

84. This exhibit illustrates the method of accounting required for a sale of property in which the seller is obligated to construct multifamily units and in which cash flow deficits are anticipated. The example applies to obligations of the seller specified in paragraphs 28-30.
FAS 66, Par. 85

85. Assumptions:
   a. Company X develops and sells multifamily residential projects. The Company performs directly all developmental activities, including initial planning, site acquisition, obtaining of financing, and physical construction of the project.
   b. During the year ended December 31, 19X1 the Company began a project of 100 units. The project was planned and substantial activity had been performed in 19X1 but physical construction had not started as of December 31, 19X1. However, all contracts had been let, and the Company had obtained construction financing.
   c. On December 31, 19X1, the Company sold the project to a limited partnership syndication (fully formed) in which it is the sole general partner:

      Sales value $1,100,000
      ========

      Represented by proceeds of:
      Cash down payment $ 165,000
      Permanent financing assumed by the buyer, consisting of a 28-year 8 1/2% fully amortizing first mortgage loan by a conventional lender, payable in equal monthly payments of principal and interest to maturity 825,000
      Second mortgage note received by the Company payable in equal monthly installments including interest at 9 1/2% over 12 years 110,000
      $1,100,000
      ========

   d. The closing occurred on December 31, 19X1 and included delivery or performance of the following:
      (1) The Company delivered to the buyer a legal title to the land and all existing improvements.
      (2) The Company delivered to the buyer a firm commitment from an outside lender for permanent financing, and the buyer assumed permanent financing formerly in the name of the Company.
      (3) The Company received from the buyer $165,000 cash and a second mortgage note for $110,000.
      (4) The Company signed a contract to deliver the completed project for a single price of $1,100,000.
e. Costs incurred by the Company and total costs estimated to complete the project, as of December 31, 19X1, were:

<table>
<thead>
<tr>
<th>Costs to Date</th>
<th>Estimated Costs to Complete</th>
<th>Total Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$117,000</td>
<td>$117,000</td>
</tr>
<tr>
<td>Feasibility, zoning, architectural</td>
<td>35,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Finance and other</td>
<td>85,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Site improvements</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Building construction</td>
<td>_________</td>
<td>571,000</td>
</tr>
<tr>
<td>Total</td>
<td>$237,000</td>
<td>$601,000</td>
</tr>
</tbody>
</table>

f. The Company has completed an extensive market research and feasibility study analyzing its cost estimates, the rent-up incubation period, and subsequent rent levels. The initial rent-up will commence in 19X2. Accordingly, a support period of two years is presumed for 19X3 and 19X4.

g. Based on its market analysis, the projected results are as follows:

<table>
<thead>
<tr>
<th></th>
<th>19X2</th>
<th>19X3</th>
<th>19X4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental expense</td>
<td>$37,000</td>
<td>$58,000</td>
<td>$58,000</td>
</tr>
<tr>
<td>Debt service</td>
<td>93,000</td>
<td>93,000</td>
<td>93,000</td>
</tr>
<tr>
<td>Total</td>
<td>130,000</td>
<td>151,000</td>
<td>151,000</td>
</tr>
<tr>
<td>Rental revenue</td>
<td>(75,000)</td>
<td>(150,000)</td>
<td>(180,000)*</td>
</tr>
</tbody>
</table>

| Anticipated net deficit (surplus) in cash flow | 55,000   | 1,000    | (29,000) |
| Safety factor of 1/3 of rental revenue         | 25,000   | 50,000   | 60,000   |
| Adjusted anticipated net deficit in cash flow    | $80,000  | $51,000  | $31,000  |

h. Initial cost estimates by the Company on previous projects have never varied from final costs by more than one-half of one % of total costs.

86. Calculations of Profit to Be Recognized:

Schedules A and B (paragraphs 87 and 88) illustrate calculations of profit to be recognized in the period of sale, in the period of construction, and in each period in which the seller will support operations (19X2 - 19X4). The following features should be noted:

a. The percentage of estimated total profit to be recognized each period is determined by the ratio of gross costs incurred to the end of the period to total estimated gross costs of the project, including gross costs during the period of support of operations. (Construction costs should be included even if construction is performed by parties other than the seller.)

b. The estimated total profit that is the basis of the calculation in each period (that is, the profit to which the percentage in (a) is applied) is determined by adding the sales value and two-thirds of the projected revenue during the period of support of operations and deducting the estimated total costs of the project, including costs of operating the property and debt service.

(1) Actual amounts of revenue and costs are substituted for estimated amounts in the calculation as the actual amounts are known. However, in this illustration, remaining
estimates of future revenue and expense are not changed because of actual results even though experience might indicate that projections of future amounts should be revised.

(2) Projected and actual revenues in the calculation should exclude amounts that accrue to the buyer, for example, revenue in excess of the sum of operating expenses and debt service.

(3) One-third of projected revenue should be excluded from the estimate of profit to provide a margin of safety (refer to paragraph 85(g)). Actual results incorporated in the calculation need not be reduced by a safety factor.

(4) The calculation illustrated should be applied only if objective information is available regarding occupancy levels and rental rates for similar property in the immediate area. This will provide reasonable assurance that rent revenue from the project will be sufficient to cover operating expenses and debt service, including payments due to the seller under the terms of the transaction. Unless that evidence is available, no profit should be recognized on the transaction until rent revenue actually reaches levels that assure coverage of those costs.

c. Schedule A shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85(g) adjusted for the safety margin of one-third of revenue.

d. Schedule B shows calculation of profit to be recognized each period on the assumption that actual revenue and costs are the same as those projected in paragraph 85(g) before adjustment for safety margin.

e. Schedule C illustrates the calculation of estimated future rent receipts by adjustment for a safety margin.

87. Schedule A

Example of Profit Calculation
(assuming actual rental revenue equals adjusted projection)

<table>
<thead>
<tr>
<th>REVENUES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales value</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Adjusted--projected rental revenue 29</td>
<td></td>
</tr>
<tr>
<td>19X2</td>
<td>50,000</td>
</tr>
<tr>
<td>19X3</td>
<td>100,000</td>
</tr>
<tr>
<td>19X4</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>1,370,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

29 Two-thirds of projected revenue during periods of support of operations; this can also be calculated as projected rental expenses plus projected service less projected deficit cash flow.

<table>
<thead>
<tr>
<th>COSTS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total estimated costs of project (paragraph 85(e))</td>
<td>838,000</td>
</tr>
<tr>
<td>Estimated rental expenses and debt service</td>
<td></td>
</tr>
<tr>
<td>19X2</td>
<td>130,000</td>
</tr>
<tr>
<td>19X3</td>
<td>151,000</td>
</tr>
<tr>
<td>19X4</td>
<td>151,000</td>
</tr>
<tr>
<td><strong>1,270,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

TOTAL PROJECTED PROFIT $100,000
Profit to be recognized:
Cost to date
Total costs x projected profit

Profit recognized in period of sale:
$ 237,000
1,270,000 x $100,000 = $18,661

Total profit to date $ 18,661
Less profit previously reported 0
Current profit recognition $ 18,661

Profit recognized in period of construction:
$ 838,000
1,270,000 x $100,000 = $65,984

Total profit to date $ 65,984
Less profit previously recognized 18,661
Current profit recognition $ 47,323

Profit recognized during support period (19X2):
$ 968,000
1,270,000 x $100,000 = $76,221

Total profit to date $ 76,221
Less profit previously recognized 65,984
Current profit recognition $ 10,237

Profit recognized during support period (19X3):
$1,119,000
1,270,000 x $100,000 = $88,110

Total profit to date $ 88,110
Less profit previously recognized 76,221
Current profit recognition $ 11,889

Profit recognized during support period (19X4):
$1,270,000
1,270,000 x $100,000 = $100,000

Total profit to date $ 100,000
Less profit previously recognized 88,110
Current profit recognition $ 11,890
Example of Profit Calculation
(assuming actual rental revenue equals unadjusted projection)
(in thousands)

<table>
<thead>
<tr>
<th>Profit Recognized in Period of Sale</th>
<th>Profit Recognized in Period of Construction</th>
<th>Profit Recognized during Support Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19X2</td>
<td>19X3</td>
</tr>
<tr>
<td>REVENUES</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales value</td>
<td>$1,100</td>
<td>$1,100</td>
</tr>
<tr>
<td>Adjusted--projected rental revenue)*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19X2</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>19X3</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>19X4</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>1,370</td>
<td>1,370</td>
</tr>
<tr>
<td>COSTS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same as Schedule A</td>
<td>$1,270</td>
<td>$1,270</td>
</tr>
<tr>
<td>TOTAL PROJECTED PROFIT</td>
<td>$100</td>
<td>$100</td>
</tr>
</tbody>
</table>

Profit to be recognized:

Cost to date
Total costs x projected profit

Profit recognized in period of sale:

$ 237,000
1,270,000 x $100,000 = $18,661

Total profit to date
Less profit previously reported
Current profit recognition

$ 18,661
0
$ 18,661

Profit recognized in period of construction:

$ 838,000
1,270,000 x $100,000 = $65,984

Total profit to date
Less profit previously reported
Current profit recognition

$ 65,984
18,661
$ 47,323

Profit recognized during support period (19X2):

$ 968,000
1,270,000 x $125,000 = $95,276

Total profit to date
Less profit previously reported
Current profit recognition

$ 95,276
65,984
$ 29,292
Profit recognized during support period (19X3):

$1,119,000
1,270,000 x $205,000 = $180,626

Total profit to date $180,626
Less profit previously reported 95,276
Current profit recognition $ 85,350

Profit recognized during support period (19X4):

$1,270,000
1,270,000 x $206,000 = $206,000

Total profit to date $206,000
Less profit previously reported $180,626
Current profit recognition $ 25,374

*Two-thirds of projected revenue during periods of support of operation; this can also be calculated as projected rental expenses plus projected debt service less projected deficit cash flow.
†Actual rental revenue.
‡Because the property has attained a level of occupancy in excess of the original adjusted projection, and there is no reason to believe that such occupancy level cannot be sustained, the projected 19X4 rental revenue should be adjusted to 19X3 actual rental revenue.
§Actual rental revenue excluding amounts not needed to meet cash flow requirements of the property.

89. Schedule C

Calculation of Adjusted Projected Rental Revenue

Assume an office building under development is sold together with an agreement to support operations of the property for three years. The projected annual rent roll is $1,000,000 of which $350,000 is supported by signed lease agreements. The projected rental revenue for the first year of operation is $600,000; the second year $750,000; and the third year $1,000,000. At the time of sale, the amounts to be included in the calculation would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Projected Rental Revenue</th>
<th>Safety Factor (33-1/3%)</th>
<th>Adjusted Projected Rental Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 600,000</td>
<td>$200,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>2</td>
<td>750,000</td>
<td>250,000</td>
<td>500,000</td>
</tr>
<tr>
<td>3</td>
<td>1,000,000</td>
<td>333,333</td>
<td>666,667</td>
</tr>
</tbody>
</table>

If at the time of sale there were signed lease agreements for $450,000, then the $450,000 would be used in year 1 because it is greater than the adjusted projected rental revenue. The adjusted projected rental revenue for years 2 and 3 would remain $500,000 and $666,667, respectively.
Exhibit III: Illustration of Profit Recognition--Installment Method, with Debt Assumed by Buyer

90. Assumptions:

Cash down payment $150,000
Second mortgage payable by buyer to seller (10-year amortization of principal plus interest) $350,000

Total cash to be received by seller $500,000
First mortgage assumed by buyer (20-year amortization of principal plus interest) $500,000

Total sales price and sales value $1,000,000
Cost $600,000
Total profit $400,000

The initial investment is assumed to be inadequate for full profit recognition, and the installment method of accounting is assumed to be appropriate. It is also assumed that, after the down payment, the buyer pays $25,000 of principal on the first mortgage and $35,000 of principal on the second mortgage.

Profit recognition: Under the installment method, profit recognition attributable to the down payment is $60,000, representing 40% ($400,000/$1,000,000) of $150,000.

Profit recognition attributable to the principal payments by the buyer on the first and second mortgages is $24,000, representing 40% of $60,000 ($25,000 + $35,000).

Appendix D: Illustrations of Calculations for Recognition of Profit on Retail Land Sales

30 The financing and interest rate assumptions in this appendix are based on conditions at the time the profit recognition Guide was issued. They should not be considered as indicative of financing and interest rate assumptions that would be appropriate under different circumstances and at different times.

Exhibits                                                                 Paragraph Numbers
I. Initial Measure of Consideration
   (Percentage-of-Completion Method) ................................................................. 91-95
   Schedule A: Present Value of Sales Contracts Receivable ............................... 92
   Schedule B: Computation of Interest Income for Financial Reporting Purposes ................................................................................................................. 93
   Schedule C: Determination of Income Tax Payable ........................................... 94
   Schedule D: Percentage-of-Completion Method-- Illustration of Financial Statement Presentation of Transactions Assumed in Paragraph 91 .................................................................................................................. 95
II. Installment Method ............................................................................................ 96-97
   Schedule A: Illustration of Financial Statement Presentation Based on Assumptions in Paragraph 91 ................................................................. 96
   Schedule B: Installment Method Changed to Percentage-of-Completion Method at Beginning of Year 4 ................................................................. 97
Exhibit I--Initial Measure of Consideration
(Percentage-of-Completion Method)
(amounts in thousands)

91. Assumptions:

Gross sales contracts recorded in year 1 (stated interest of 6%) $1,000

Estimated uncollectible principal amount (sales contracts of $200* less estimated down payments to be forfeited of $20) (180)

Net sales contracts receivable 820
Down payments and collections in year 1 relative to above sales contracts ($80 + $20) 100

Collections projected (principal amounts) for years 2 through 10 $ 720

Land cost (applicable to sales contracts of $800) $ 60
Selling expenses in year 1 300
Future improvement costs (applicable to sales contracts of $800) 120
Minimum annual yield required on contracts receivable 12%

Discount Required:
Sales contracts receivable in year 1 (see above) $ 720
Present value of 108 level monthly payments of $8.65 on sales contracts receivable (discounted at 12%) (Schedule A) 570
Discount required $ 150

Computation of Revenue Applicable to Future Improvements:

$120

$60 + $300 + $120 = 25%

25% x $650($1,000 - $200 - $150) = $163

Profit Recognition in Year 1:

Revenue recognized:
Cash received in year 1 $ 100
Present value of balance of sales contracts receivable 570
(Net sales $820, less discount $150) 670

Less: revenue applicable to future improvements 163

Net revenue 507
Less: Costs and expenses ($60 + $300) 360

Pretax income $ 147

*It is assumed that 90% of contracts in force 6 months after sales are recognized will ultimately be collected in full (paragraph 45).
92. Schedule A

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Collections</th>
<th>Interest* Collections</th>
<th>Present Value @ 12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$62</td>
<td>$42</td>
<td>$97</td>
</tr>
<tr>
<td>3</td>
<td>66</td>
<td>38</td>
<td>87</td>
</tr>
<tr>
<td>4</td>
<td>70</td>
<td>34</td>
<td>77</td>
</tr>
<tr>
<td>5</td>
<td>75</td>
<td>29</td>
<td>68</td>
</tr>
<tr>
<td>6</td>
<td>79</td>
<td>25</td>
<td>60</td>
</tr>
<tr>
<td>7</td>
<td>84</td>
<td>20</td>
<td>53</td>
</tr>
<tr>
<td>8</td>
<td>89</td>
<td>15</td>
<td>47</td>
</tr>
<tr>
<td>9</td>
<td>95</td>
<td>9</td>
<td>43</td>
</tr>
<tr>
<td>10</td>
<td>100</td>
<td>4</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td><strong>$720</strong></td>
<td><strong>$216</strong></td>
<td><strong>$936</strong></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>$570</strong></td>
</tr>
</tbody>
</table>

*Assumes no interest for year 1.

93. Schedule B

Computation of Interest Income for Financial Reporting Purposes (amounts in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash</th>
<th>Discount</th>
<th>Valuation Receivable</th>
<th>Interest Income*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$104</td>
<td>24</td>
<td>(62)</td>
<td>(66)</td>
</tr>
<tr>
<td>3</td>
<td>104</td>
<td>24</td>
<td>(66)</td>
<td>(62)</td>
</tr>
<tr>
<td>4</td>
<td>104</td>
<td>22</td>
<td>(70)</td>
<td>(56)</td>
</tr>
<tr>
<td>5</td>
<td>104</td>
<td>21</td>
<td>(75)</td>
<td>(50)</td>
</tr>
<tr>
<td>6</td>
<td>104</td>
<td>19</td>
<td>(79)</td>
<td>(44)</td>
</tr>
<tr>
<td>7</td>
<td>104</td>
<td>16</td>
<td>(84)</td>
<td>(36)</td>
</tr>
<tr>
<td>8</td>
<td>104</td>
<td>12</td>
<td>(89)</td>
<td>(27)</td>
</tr>
<tr>
<td>9</td>
<td>104</td>
<td>8</td>
<td>(95)</td>
<td>(17)</td>
</tr>
<tr>
<td>10</td>
<td>104</td>
<td>4</td>
<td>(100)</td>
<td>(8)</td>
</tr>
<tr>
<td></td>
<td><strong>$936</strong></td>
<td><strong>$150</strong></td>
<td><strong>$(720)</strong></td>
<td><strong>$(366)</strong></td>
</tr>
</tbody>
</table>

*Total interest income equals $216 stated interest plus $150 discount, or $366.

94. Schedule C

Determination of Income Tax Payable (amounts in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Receipts</th>
<th>Profit from Sale</th>
<th>Interest Income from Receivable</th>
<th>Selling Expense</th>
<th>Taxable Income</th>
<th>Tax (Loss)</th>
<th>Tax Effect of Loss Carry-forward Net from Year 1 Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100</td>
<td>$82*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>62</td>
<td>48</td>
<td>$42</td>
<td>90</td>
<td>$(43)</td>
<td>$43</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>66</td>
<td>51</td>
<td>38</td>
<td>89</td>
<td>(43)</td>
<td>43</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>70</td>
<td>54</td>
<td>34</td>
<td>88</td>
<td>(42)</td>
<td>19</td>
<td>($23)</td>
</tr>
<tr>
<td>5</td>
<td>75</td>
<td>58</td>
<td>29</td>
<td>87</td>
<td>(42)</td>
<td>(42)</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>79</td>
<td>61</td>
<td>25</td>
<td>86</td>
<td>(41)</td>
<td>(41)</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>84</td>
<td>65</td>
<td>20</td>
<td>85</td>
<td>(41)</td>
<td>(41)</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>89</td>
<td>69</td>
<td>15</td>
<td>84</td>
<td>(40)</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>95</td>
<td>74</td>
<td>9</td>
<td>83</td>
<td>(40)</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>100</td>
<td>78</td>
<td>4</td>
<td>82</td>
<td>(40)</td>
<td>(40)</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>$820</strong></td>
<td><strong>$640</strong></td>
<td><strong>$216</strong></td>
<td><strong>$(300)</strong></td>
<td><strong>$556</strong></td>
<td><strong>$(372)</strong></td>
<td><strong>$105† ($267)</strong></td>
</tr>
</tbody>
</table>

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Assumption: The installment method is used for income tax purposes.

* Profit on land sale computed on installment method as follows:
  Gross profit = $800 - $180 = $620
  Principal payment X profit margin: $80 x $620 = $62
  $800
  Forfeited down payments: 20
  $82
  ===
  †Carryforward amount is 48% of $218 = $105.

95. Schedule D

Percentage-of-Completion Method-Illustration of Financial Statement
Presentation of Transactions Assumed in Paragraph 91
(amounts in thousands)

<table>
<thead>
<tr>
<th>End of Year</th>
<th>Beginning</th>
</tr>
</thead>
<tbody>
<tr>
<td>of Year 1</td>
<td>1</td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$300</td>
</tr>
<tr>
<td>Contracts receivable</td>
<td>720</td>
</tr>
<tr>
<td>Less: Allowance for contract cancellations*</td>
<td>--</td>
</tr>
<tr>
<td>Unamortized valuation discount</td>
<td>(150)</td>
</tr>
<tr>
<td>Land</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>$375</td>
</tr>
</tbody>
</table>

Liabilities and equity:
Deferred income taxes | $  71      | $103      | $133      | $137      | $119      | $100      | $  81      | $  59      | $  32      |
Revenue applicable to future improvements† | 163      | 163      | 163      | 163      | 163      | 122      | 81        | 40        |
Capital stock | $375      | 375      | 375      | 375      | 375      | 375      | 375      | 375      |
Retained earnings | 76        | 110      | 142      | 171      | 197      | 219      | 244      | 264      | 279      | 289      |
| $375        | $685      | $751      | $813      | $846      | $854      | $857      | $822      | $779      | $726      | $664      |

Income Statements

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Sales</td>
<td>$1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Less: Estimated uncollectible sales</td>
<td>(180)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(180)</td>
</tr>
<tr>
<td>Revenue applicable to future improvements</td>
<td>(163)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(163)</td>
</tr>
<tr>
<td>Valuation discount</td>
<td>(150)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(150)</td>
</tr>
<tr>
<td>Net sales</td>
<td>507</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>507</td>
</tr>
</tbody>
</table>
Improvement revenue--prior sales $ 41 $ 41 $ 41 $ 40 163

Interest income (Schedule B) $ 66 $ 62 $ 56 $ 50 $ 44 $ 36 $ 27 $ 17 $ 8 $ 366

507 66 62 56 50 44 77 68 58 48 1,036

Costs and expenses:

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>60</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improvement costs--prior sales</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>120</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Selling expenses</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
<td>360</td>
</tr>
<tr>
<td>Income before provision for income taxes</td>
<td>147</td>
<td>66</td>
<td>62</td>
<td>56</td>
<td>50</td>
<td>44</td>
<td>47</td>
<td>38</td>
<td>28</td>
<td>556</td>
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</table>

Provision for income taxes:

<table>
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<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>23</td>
<td>42</td>
<td>41</td>
<td>41</td>
<td>40</td>
<td>40</td>
<td>40</td>
<td>267</td>
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<td></td>
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<tr>
<td>Deferred</td>
<td>71</td>
<td>32</td>
<td>30</td>
<td>4</td>
<td>(18)</td>
<td>(19)</td>
<td>(19)</td>
<td>(22)</td>
<td>(27)</td>
<td>(32)</td>
</tr>
</tbody>
</table>

Net Income $ 76 $ 34 $ 29 $ 26 $ 22 $ 25 $ 20 $ 15 $ 10 $ 289

* Assumes that all cancellations occurred in year 1 without refunds of down payments.
† Assumes that future performance occurred equally in years 7, 8, 9, and 10.

Note: The illustrative statements are not intended to represent retail land sales company financial statements because they include only items necessary to illustrate timing of revenue and income recognition.

EXHIBIT II--INSTALLMENT METHOD

96. Schedule A

Illustration of Financial Statement Presentation
Based on Assumptions in Paragraph 91
(amounts in thousands)

<table>
<thead>
<tr>
<th></th>
<th>Beginning</th>
<th>End of Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Of Year 1</td>
<td>1</td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
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<tr>
<td>Cash</td>
<td>$300</td>
<td>$100</td>
</tr>
<tr>
<td>Contracts receivable</td>
<td>720</td>
<td>658</td>
</tr>
<tr>
<td>Less: Profit applicable future improvements</td>
<td>(342) (313) (282) (249) (213) (175) (135) (93) (48)</td>
<td>378</td>
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<tr>
<td>Land</td>
<td>75</td>
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</tr>
<tr>
<td>$375</td>
<td>$493</td>
<td>$564</td>
</tr>
</tbody>
</table>

Liabilities and equity:

|                      |      |      |      |      |      |      |      |      |      |      |
| Deferred income taxes| $ 33 | $ 66 | $ 75 | $ 64 | $ 54 | $ 42 | $ 29 | $ 15 |      |      |
| Liability for future improvements | $120 | $120 | $120 | $120 | $120 | $120 | $ 90 | $ 60 | $ 30 |      |
| Capital stock        | $375  | 375  | 375  | 375  | 375  | 375  | 375  | 375  | 375  | 375  |
| Retained earnings (deficit) | (2)  | 36   | 72   | 107  | 141  | 173  | 204  | 234  | 262  | 289  |
| $375                 | $493   | $564 | $633 | $677 | $700 | $722 | $711 | $698 | $682 | $664 |

© 1999-2005 National Association of Insurance Commissioners
<table>
<thead>
<tr>
<th>Point of Sale in Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Year 7</th>
<th>Year 8</th>
<th>Year 9</th>
<th>Year 10</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Sales</td>
<td>$1,000</td>
<td>$1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Interest income</td>
<td>$42</td>
<td>$38</td>
<td>$34</td>
<td>$29</td>
<td>$25</td>
<td>$20</td>
<td>$15</td>
<td>$9</td>
<td>$4</td>
<td></td>
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<td>Profit deferred*</td>
<td>(427)</td>
<td>(427)</td>
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<td></td>
<td></td>
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<td></td>
<td>(427)</td>
</tr>
<tr>
<td>Profit recognized†</td>
<td>29</td>
<td>31</td>
<td>33</td>
<td>36</td>
<td>40</td>
<td>42</td>
<td>45</td>
<td>48</td>
<td></td>
<td></td>
<td>342</td>
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<tr>
<td>Total</td>
<td>573</td>
<td>573</td>
<td>71</td>
<td>69</td>
<td>67</td>
<td>65</td>
<td>63</td>
<td>60</td>
<td>57</td>
<td>54</td>
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<td>Costs and expenses:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Cost of Sales‡</td>
<td>225</td>
<td>225</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td>300</td>
</tr>
<tr>
<td>Loss on cancellations§</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>Income (loss) before provision for income taxes</td>
<td>48</td>
<td>(2)</td>
<td>71</td>
<td>69</td>
<td>67</td>
<td>65</td>
<td>63</td>
<td>60</td>
<td>57</td>
<td>54</td>
<td>52</td>
</tr>
<tr>
<td>Provision for income taxes:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>23</td>
<td></td>
<td>33</td>
<td></td>
<td>9</td>
<td></td>
<td>(11)</td>
<td></td>
<td>(10)</td>
<td>(12)</td>
<td>(13)</td>
</tr>
<tr>
<td>Deferred</td>
<td></td>
<td>33</td>
<td></td>
<td>32</td>
<td>31</td>
<td>29</td>
<td>27</td>
<td>26</td>
<td>25</td>
<td></td>
<td>267</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$25</td>
<td>$ (2)</td>
<td>$38</td>
<td>$36</td>
<td>$35</td>
<td>$34</td>
<td>$32</td>
<td>$31</td>
<td>$30</td>
<td>$28</td>
<td>$27</td>
</tr>
</tbody>
</table>

Notes to Exhibit II, Schedule A
(amounts in thousands)

*Computation of profit deferred:
  Sales $1,000
  Cost of sales (see Note‡) (225)
  Selling expense (300)
  Profit $475
  Percentage 47.5%
  Uncollected receivables $900
  Profit percentage 47.5%
  Profit deferred $427

†Profit recognized is 47.5% of principal collections.
‡Costs applicable to gross sales contracts:
  Land $75
  Future development 150
  $225

§Loss on cancellations:
  Contracts cancelled in Year 1 $200
  Unpaid balance $180

Costs recovered (credited to cost of sales):
  Land at cost $15
  Future development 30 (45)
  Profit at 47.5% of $180 (85)
  Unrecovered selling cost $50
97. Schedule B

**Installment Method Changed to Percentage-of-Completion Method at Beginning of Year 4**
(amounts in thousands)

### Balance Sheets

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$100</td>
<td>$204</td>
<td>$308</td>
<td>$389</td>
<td>$451</td>
<td>$514</td>
<td>$547</td>
<td>$581</td>
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<td>Contracts receivable</td>
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<td>592</td>
<td>522</td>
<td>447</td>
<td>368</td>
<td>284</td>
<td>195</td>
<td>100</td>
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</tr>
<tr>
<td>Less: Profit applicable to future improvements</td>
<td>(342)</td>
<td>(313)</td>
<td>(282)</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Unamortized valuation discount</td>
<td>(80)</td>
<td>(59)</td>
<td>(40)</td>
<td>(24)</td>
<td>(12)</td>
<td>(4)</td>
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<td></td>
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<tr>
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<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
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<tr>
<td><strong>Total:</strong></td>
<td>$493</td>
<td>$564</td>
<td>$633</td>
<td>$846</td>
<td>$854</td>
<td>$857</td>
<td>$822</td>
<td>$779</td>
<td>$726</td>
<td>$664</td>
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</table>

### Liabilities and equity:

<table>
<thead>
<tr>
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<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deferred income taxes:</strong></td>
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<td>Liability for future improvements (revenue applicable to future improvements after Year 3)</td>
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<td>120</td>
<td>120</td>
<td>163</td>
<td>163</td>
<td>163</td>
<td>122</td>
<td>81</td>
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<td>Capital stock</td>
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<td>375</td>
<td>375</td>
<td>375</td>
<td>375</td>
<td>$375</td>
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<td><strong>Retained earnings (deficit):</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(2)</td>
<td>36</td>
<td>72</td>
<td>171</td>
<td>197</td>
<td>219</td>
<td>244</td>
<td>264</td>
<td>279</td>
<td>289</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>$493</td>
<td>$564</td>
<td>$633</td>
<td>$846</td>
<td>$854</td>
<td>$857</td>
<td>$822</td>
<td>$779</td>
<td>$726</td>
<td>$664</td>
</tr>
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</table>

### Income Statements

<table>
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<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross sales contracts recorded</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improvement revenue--prior sales</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit deferred</td>
<td>(427)</td>
<td>(427)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit recognized</td>
<td>$29</td>
<td>$31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income*</td>
<td>42</td>
<td>38</td>
<td>$56</td>
<td>$50</td>
<td>$44</td>
<td>36</td>
<td>27</td>
<td>17</td>
<td>8</td>
<td></td>
<td>318</td>
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<tr>
<td>Income resulting from change from installment to percentage-of-completion method† (described fully in notes to financial statements)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>137</td>
<td>137</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>573</td>
<td>71</td>
<td>69</td>
<td>193</td>
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<td>44</td>
<td>77</td>
<td>68</td>
<td>58</td>
<td>48</td>
<td>1,251</td>
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Costs and expenses:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of sales</td>
<td>225</td>
</tr>
<tr>
<td>Improvement costs--</td>
<td></td>
</tr>
<tr>
<td>prior sales</td>
<td>30 30 30 30 120</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>300</td>
</tr>
<tr>
<td>Loss on cancellations</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>575</td>
</tr>
</tbody>
</table>

Income (loss) before provision for income taxes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2)</td>
<td>71 69 193 50 44 47 38 28 18 556</td>
</tr>
</tbody>
</table>

Provision for income taxes:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>23 42 41 41 40 40 40 267</td>
</tr>
<tr>
<td>Deferred</td>
<td>33 33 71 (18) (19) (19) (22) (27) (32)</td>
</tr>
<tr>
<td></td>
<td>33 33 94 24 22 22 18 13 8 267</td>
</tr>
</tbody>
</table>

Net income (loss):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ (2)</td>
<td>$38 $36 $99 $26 $22 $25 $20 $15 $10 $289</td>
</tr>
</tbody>
</table>

**Notes to Exhibit II, Schedule B:**

* Interest at stated rate for Years 2 and 3; 12% after change from installment to percentage-of-completion method.

† Computation of effect of change from installment to percentage-of-completion method:

(Amounts in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amounts (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit not yet recognized under installment method:</td>
<td></td>
</tr>
<tr>
<td>Original</td>
<td>$427</td>
</tr>
<tr>
<td>Recognized in prior years</td>
<td>(60)</td>
</tr>
<tr>
<td>Applicable to canceled contracts</td>
<td>(85)  $282</td>
</tr>
<tr>
<td>Less, valuation discount required:</td>
<td></td>
</tr>
<tr>
<td>Receivables at beginning of year 4</td>
<td>592</td>
</tr>
<tr>
<td>Present value of payments due (principal and interest) at 12%</td>
<td>(490)  102 180</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Revenue to be recognized in future as performance takes place</td>
<td>163</td>
</tr>
<tr>
<td>Costs to be recognized in future</td>
<td>(120)  43</td>
</tr>
<tr>
<td>Net amount credited to income (before taxes)</td>
<td>$137</td>
</tr>
</tbody>
</table>

30. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, provides the following guidance:

1. This Statement establishes accounting and reporting standards for acquisition, development, construction, selling, and rental costs associated with real estate projects. It also provides guidance for the accounting for initial rental operations and criteria for determining when the status of a rental project changes from nonoperating to operating.
SCOPE AND APPLICABILITY

2. This Statement does not apply to:

   a. Real estate developed by an enterprise for use in its own operations,\(^1\) other than for sale or rental.

\(^1\) In this context, “real estate developed by an enterprise for use in its own operations” includes real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent’s operations) when the property is reported in the group’s consolidated financial statements. However, such property is not “real estate developed for use in the enterprise’s operations” when reported in the separate financial statements of the entity that developed it.

   b. “Initial direct costs” of sales-type, operating, and other types of leases, which are defined in FASB Statement No. 17, Accounting for Leases—Initial Direct Costs. The accounting for initial direct costs is prescribed in FASB Statement No. 13, Accounting for Leases.

   c. Costs directly related to manufacturing, merchandising, or service activities as distinguished from real estate activities.

   Paragraphs 20-23 of this Statement do not apply to real estate rental activity in which the predominant rental period is less than one month.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General

3. Paragraphs 4-25 specify the accounting for the following as they relate to real estate projects:

   (a) preacquisition costs\(^2\) (b) taxes and insurance, (c) project costs, (d) amenities, (e) incidental operations, (f) allocation of capitalized costs to components of a real estate project, (g) revisions of estimates, (h) abandonments and changes in use, (i) selling costs, (j) rental costs, and (k) costs in excess of estimated net realizable value.

\(^2\) Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

Acquisition, Development, and Construction Costs

Preacquisition Costs

4. Payments to obtain an option to acquire real property shall be capitalized as incurred. All other costs related to a property that are incurred before the enterprise acquires the property, or before the enterprise obtains an option to acquire it, shall be capitalized if all of the following conditions are met and otherwise shall be charged to expense as incurred:

   a. The costs are directly identifiable with the specific property.

   b. The costs would be capitalized if the property were already acquired.

   c. Acquisition of the property or of an option to acquire the property is probable.\(^3\) This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

\(^3\) Probable is defined in FASB Statement No. 5, Accounting for Contingencies, as “likely to occur” and is used in the same sense in this Statement.
5. Capitalized Preacquisition costs (a) shall be included as project costs upon the acquisition of the property or (b) to the extent not recoverable by the sale of the options, plans, etc., shall be charged to expense when it is probable that the property will not be acquired.

Taxes and Insurance

6. Costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress.\(^4\) Costs incurred for such items after the property is substantially complete and ready for its intended use\(^5\) shall be charged to expense as incurred.

\(^4\) The phrase activities necessary to get the property ready for its intended use are in progress is used here with the same meaning as it has for interest capitalization in paragraph 17 of FASB Statement No. 34, Capitalization of Interest Cost.

\(^5\) The phrase substantially complete and ready for its intended use is used here with the same meaning as it has for interest capitalization in paragraph 18 of Statement 34.

Project Costs

7. Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized as a cost of that project. Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate. Indirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses, shall be charged to expense as incurred.

Amenities

8. Accounting for costs of amenities shall be based on management's plans for the amenities in accordance with the following:

a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds shall be allocated as common costs because the amenity is clearly associated with the development and sale of the project. The common costs include expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project.

b. If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated fair value as of the expected date of its substantial physical completion shall be allocated as common costs. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity shall not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that shall be included in net income in the period in which the sale occurs.

Costs of amenities shall be allocated among land parcels\(^6\) benefited and for which development is probable.

\(^6\) A land parcel may be considered to be an individual lot or unit, an amenity, or a phase.

9. Before an amenity is substantially completed and available for use, operating income (or loss) of the amenity shall be included as a reduction of (or an addition to) common costs. When an amenity to be sold separately or retained by the developer is substantially completed and available for use, current operating income and expenses of the amenity shall be included in current operating results.
Incidental Operations

10. Incremental revenue from incidental operations in excess of incremental costs of incidental operations shall be accounted for as a reduction of capitalized project costs. Incremental costs in excess of incremental revenue shall be charged to expense as incurred, because the incidental operations did not achieve the objective of reducing the costs of developing the property for its intended use.

Allocation of Capitalized Costs to the Components of a Real Estate Project

11. The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

   a. Land cost and all other common costs\(^7\) (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.

   \(^7\) Including the costs of amenities to be allocated as common costs (paragraphs 8 and 9).

   b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

Revisions of Estimates

12. Estimates and cost allocations shall be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs shall be revised and reallocated as necessary for material changes on the basis of current estimates.\(^8\) Changes in estimates shall be reported in accordance with paragraph 31 of APB Opinion No. 20, Accounting Changes.

\(^8\) Paragraph 76 of Statement No. 66, Accounting for Sales of Real Estate, discusses revisions of estimates relating to retail land sales accounted for by the percentage-of-completion method.

Abandonments and Changes in Use

13. If real estate, including rights to real estate, is abandoned (for example, by allowing a mortgage to be foreclosed or a purchase option to lapse), capitalized costs of that real estate shall be expensed. Such costs shall not be allocated to other components of the project or to other projects even if other components or other projects are capable of absorbing the losses.

14. Real estate donated to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the real estate donated shall be allocated as a common cost of the project.

15. Changes in the use of real estate comprising a project or a portion of a project may arise after significant development and construction costs have been incurred. If the change in use is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before change), the development and construction costs to be charged to expense shall be limited to the amount by which the capitalized costs incurred
and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

16. In the absence of a formal plan for a project that is expected to produce a higher economic yield, the project costs to be charged to expense shall be limited to the amount by which total project costs exceed the estimated net realizable value of the property determined on the assumption it will be sold in its present state.

Costs Incurred to Sell and Rent Real Estate Projects, Including Initial Rental Operations

Costs Incurred to Sell Real Estate Projects

17. Costs incurred to sell real estate projects shall be capitalized if they (a) are reasonably expected to be recovered from the sale of the project or from incidental operations and (b) are incurred for (1) tangible assets that are used directly throughout the selling period to aid in the sale of the project or (2) services that have been performed to obtain regulatory approval of sales. Examples of costs incurred to sell real estate projects that ordinarily meet the criteria for capitalization are costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

18. Other costs incurred to sell real estate projects shall be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual. Costs that do not meet the criteria for capitalization shall be expensed as incurred.

Costs Incurred to Rent Real Estate Projects

20. If costs incurred to rent real estate projects, other than initial direct costs, under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples of such costs are costs of model units and their furnishings, rental facilities, semipermanent signs, “grand openings,” and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead.

21. Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated.

References:

9 FASB Statement 66 discusses the circumstances under which the appropriate accounting methods are to be applied, including the full accrual method.

10 Initial direct costs are defined in Statement 17. The accounting for initial direct costs is prescribed in Statement 13.

11 Refer to paragraph 22 for the definition of substantially completed and held available for occupancy.
Initial Rental Operations

22. When a real estate project is substantially completed and held available for occupancy, rental revenues and operating costs shall be recognized in income and expense as they accrue, all carrying costs (such as real estate taxes) shall be charged to expense when incurred, depreciation on the cost of the project shall be provided, and costs to rent the project shall be amortized in accordance with paragraph 21 of this Statement. A real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup).

23. If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy and other portions have not yet reached that stage, the substantially completed portions shall be accounted for as a separate project. Costs incurred shall be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

Recoverability

24. The carrying amount of a real estate project, or parts thereof, held for sale or development and sale shall not exceed net realizable value. If costs exceed net realizable value, capitalization of costs associated with development and construction of a property shall not cease, but rather an allowance shall be provided to reduce the carrying amount to estimated net realizable value, determined on the basis of an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a subdivision and amenities). Therefore, a multi phase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

25. Evidence of insufficient rental demand for a rental project currently under construction may indicate an impairment of the carrying value. If it is probable that the insufficient rental demand is other than temporary, an allowance for losses shall be provided, whether or not construction is actually suspended.

Amendments to Other Pronouncement

26. The references to AICPA Statements of Position 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, and 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, are deleted from Appendixes A and B of FASB Statement No. 32, Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters, respectively.

Effective Date and Transition

27. This Statement shall be applied to costs of real estate projects incurred in fiscal years beginning after December 31, 1982. Earlier application is encouraged but not required.

31. AICPA Statement of Position 92-3, Accounting for Foreclosed Assets, provides the following guidance:

Scope

.01 This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets\(^1\) after foreclosure. (Paragraphs A-6 and A-7 of the Appendix [paragraph .18] discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers,
futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (a) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins; (b) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, Accounting for Certain Marketable Securities; and (c) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects. Except for the requirements in paragraphs .12 and .17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix [paragraph .18]).

1As used in this SOP, the term foreclosed assets includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

Background

.02 Paragraph 29 of FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, issued in 1977, requires the following: “After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash.” That requirement has been interpreted in diverse ways.

.03 The American Institute of Certified Public Accountants’ (AICPA’s) Industry Audit Guide Audits of Stock Life Insurance Companies requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, Accounting Practices of Real Estate Investment Trusts [section 10,060.17 and .21] (as amended by SOP 78-2 [section 10,170]), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide Audits of Savings Institutions and in the Industry Audit Guide Audits of Finance Companies are consistent with SOPs 75-2 [section 10,060] and 78-2 [section 10,170]. The AICPA Industry Audit Guide Audits of Banks states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide Audits of Property and Liability Insurance Companies does not address accounting for foreclosed assets. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

.08 AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.
This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. SOP 75-2, Accounting Practices of Real Estate Investment Trusts, paragraphs 15-23, 25, 27, 28, 29a, 29b, and 29c [section 10,060]

b. SOP 78-2, Accounting Practices of Real Estate Investment Trusts, paragraph 6 [section 10,170.06]

c. Audits of Banks

d. Audits of Savings Institutions

e. Audits of Finance Companies

f. Audits of Property and Liability Insurance Companies

g. Audits of Stock Life Insurance Companies

h. Guide for the Use of Real Estate Appraisal Information

Conclusions

Held-for-Sale Presumption

Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

The presumption of sale can be rebutted if (a) management intends to hold a foreclosed asset for the production of income, (b) that intent is not inconsistent with the enterprise’s ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (c) that intent is supported by a preponderance of the evidence.

First, after foreclosure, foreclosed assets held for sale should be carried at the lower of (a) fair value minus estimated costs to sell or (b) cost. Such determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.

2 Fair value, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

Fair value, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows: The fair value of the assets transferred is the amount that the [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.

6 Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of APB [Accounting Principles Board] Opinion No. 16 ["Business Combinations"], paragraphs 12-14 of APB Opinion No. 21, "Interest on Receivables and Payables," and paragraph 25 of APB Opinion No. 29, "Accounting for Nonmonetary Transactions."

3 The cost of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the Appendix [paragraph .18]).
Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, was extracted by the FASB from SOP 78-3, Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects; SOP 80-3, Accounting for Real Estate Acquisition, Development, and Construction Costs, and the AICPA Industry Audit Guide Accounting for Retail Land Sales. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (a) the fair value of the asset minus the estimated costs to sell the asset or (b) the cost of the asset as of the date of the initial adoption of this SOP. For many enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative effect adjustments as of the beginning of the year this SOP is first applied is permitted.

FASB Emerging Issues Task Force Issue No. 86-6, *Antispeculation Clauses in Real Estate Sales Contracts* provides the following guidance relating to the use of “antispeculation” clauses:

**ISSUE**

Land sale agreements sometimes contain “antispeculation” clauses that require the buyer to develop the land in a specific manner or within a stated period of time. Antispeculation clauses may also prohibit certain uses of the property. If the buyer fails to comply with the provisions of
the sales contract, the seller has the right, but not the obligation, to reacquire the property. Paragraph 26 of Statement 66 states that, if the terms of a transaction give the seller an option to repurchase the property, then the transaction is accounted for as a financing, leasing, or profit-sharing arrangement rather than as a sale.

The issue is whether Statement 66 precludes the seller from accounting for the transaction as a sale when an antispeculation clause exists.

EITF DISCUSSION

The Task Force reached a consensus that the contingent option described would not preclude recognition of a sale if the probability of the buyer not complying is remote. Task Force members described a number of factors that would lead them to conclude that buyer noncompliance is remote, including the economic loss to the buyer from repurchase and the buyer's perceived ability to comply with the provisions of the sales contract. Task Force members also indicated that a probability test would not be appropriate if the seller's repurchase option is not contingent upon compliance by the buyer.

33. FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds, allows the modification of the down payment criteria established in FAS 66. For a seller of owner-occupied single-family residential homes that are financed under a FHA or VA government-insured program, the down payment criteria set forth in paragraphs 53 and 54 of FAS 66 is modified to the normal down payment requirements or loan limits established under those programs and profit may be recorded under the full accrual method provided that the mortgage receivable is insured from loss under the FHA or VA program. EITF 87-9 provides the following guidance:

ISSUE

Financial institutions and other sellers of real estate may require mortgage insurance on a portion of the financing provided to the buyer by the seller, particularly in transactions involving residential property. In addition, surety bonds may be accepted by sellers of real estate to support the buyer's notes in lieu of an irrevocable letter of credit.

Paragraph 9 of Statement 66 provides that "the buyer's notes supported by irrevocable letters of credit from an independent established lending institution" may be included as part of the buyer's initial and continuing investment in determining whether it is appropriate for a seller of real estate to recognize profit on a transaction under the full accrual method. The issues are:

1. Whether a financial instrument (such as a surety bond) may be considered equivalent to an irrevocable letter of credit in determining whether it is appropriate to recognize income under the full accrual method if (a) the seller's rights of collection, (b) the surety's obligation for payment, and (c) the surety's recourse to the buyer under the instrument in the event of default are the same as for an irrevocable letter of credit.

2. Whether government or private mortgage insurance covering a part of the mortgage balance should be considered equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method.

A related subissue is whether the minimum down payment percentages set forth in Statement 66 apply or whether the loan limits in the government programs may be used if a buyer of single-family residential property qualifies for a Federal Housing Administration (FHA) or Veterans Administration (VA) loan that requires little (less than 5 percent) or no down payment and the principal amount of the mortgage is insured or guaranteed either in full or in part by the FHA or VA. Paragraph 11 of Statement 66 requires an initial investment that is adequate to demonstrate the buyer's commitment to pay for the property and is "equal to at least a major part of the
difference between usual loan limits and the sale's value of the property.” Paragraphs 53 and 54 of Statement 66 provide guidance on the minimum initial investment in the property required by the buyer to demonstrate a commitment to pay for the property that is necessary for the seller to recognize profit under the full accrual method.

EITF DISCUSSION

On the first issue, the Task Force reached a consensus that an irrevocable financial instrument, such as a surety bond, from an established independent insuring institution that includes the preceding characteristics (such that the instrument has all the rights and obligations of an irrevocable letter of credit) may be considered by the seller to be equivalent to an irrevocable letter of credit and included as part of the buyer's initial and continuing investment in determining whether it is appropriate to recognize profit under the full accrual method. The Task Force noted that the requirement in Statement 66 to demonstrate the buyer's commitment to pay is an important criterion that must be met before profit is recognized by the full accrual method.

On the second issue, the Task Force reached a consensus that mortgage insurance should not be considered the equivalent of an irrevocable letter of credit in the determination of whether it is appropriate to recognize profit under the full accrual method because the purchase of mortgage insurance is not deemed to demonstrate a commitment by the buyer to honor its obligation to pay for the property.

With respect to the subissue, the Task Force reached a consensus that a seller of owner-occupied single-family residential homes that finances a sale under an FHA or VA government-insured program may use the normal down payment requirements or loan limits established under those programs as a surrogate for the down payment criteria set forth in paragraphs 53 and 54 of Statement 66 and may record profit under the full accrual method provided that the mortgage receivable is fully insured from loss under the FHA or VA program. In that specific circumstance, the Task Force believes that departure from the minimum initial investment criteria of Statement 66 is justified because all of the credit risk associated with the receivable from the sale is transferred to the governmental agency. However, the Task Force emphasized that in all other circumstances (for example, FHA or VA programs that provide for less than full insurance or seller financing using private mortgage insurance) the minimum initial investment criteria set forth in Statement 66 should be followed.

Subsequently, several Task Force members indicated that they did not recall the consensus being limited to transactions that are fully insured under the FHA and VA programs. Some Task Force members indicated their belief that the consensus should be applied to all sales of residential property for which the seller provides financing under the FHA or VA program and the buyer has complied with the normal lending terms for those programs in the specific location of the property, irrespective of whether the mortgage is fully insured. Others suggested that they are uncomfortable addressing transactions that are not fully insured under those programs without a better understanding of how the programs insure the seller in the event of a default by the buyer.

At a subsequent meeting, the Task Force discussed the FHA mortgage insurance program and the VA loan guarantee program with representatives from the FHA and the VA. An FHA representative confirmed that the FHA program normally insures 100 percent of the outstanding mortgage principal, and a VA representative stated that the VA program generally provides first-dollar loss coverage of either 40 or 50 percent of the qualified loan amount, but coverage of not more than $36,000. Coverage under the VA program is reduced on a pro rata basis as the principal of the loan is paid off. Neither program provides for split coverage with private insurers. Also, in the event of a default by the borrower, both the FHA and the VA programs provide for recourse against the borrower.

The Task Force reached a consensus that the term fully should be deleted from the consensus reached above, thus permitting profit recognition under the full accrual method for all loans insured under the current FHA or VA programs. Task Force members noted that the consensus applies only to FHA and VA coverage and not to private mortgage insurance.
34. FASB Emerging Issues Task Force Issue 87-29, *Exchange of Real Estate Involving Boot* (EITF 87-29), suggests that a seller should follow FAS 66 for the monetary portion of a transaction involving an exchange of real estate involving boot. EITF 87-29 provides the following guidance:

**ISSUE**

Statement 66 indicates that the accounting for exchanges of real estate is covered by Opinion 29, which addresses nonmonetary transactions, and not by Statement 66. However, in Issue No. 86-29, “Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value,” the Task Force reached a consensus that an exchange of nonmonetary assets that would otherwise be based on recorded amounts under paragraph 21 of Opinion 29 but that involves boot should be considered a monetary (rather than nonmonetary) transaction if the boot is at least 25 percent of the fair value of the exchange. As a result of that consensus, an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar real estate would be recorded by both parties based on fair value when the boot is at least 25 percent of the fair value of the exchange. (Those types of exchanges will be referred to in this Issue as exchanges of similar real estate.) The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite for the use of fair value. If the boot in an exchange of similar real estate is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 would be applied by the receiver of boot, and the payer of boot would not recognize a gain.

The issues are:

1. Whether Statement 66 applies to an exchange of similar real estate that is not subject to Opinion 29 because the transaction involves enough boot for the exchange to be considered monetary under the consensus for Issue 86-29
2. If applicable, how Statement 66 should be applied.

**EITF DISCUSSION**

The Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of this consensus.
35. FASB Emerging Issues Task Force Issue No. 88-12, *Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66* provides the following guidance on accounting for sales of real estate:

**ISSUE**

Party A has a 75 percent interest in real estate and Party B has the other 25 percent interest. Party A sells its interest to Party B and receives a 10 percent cash down payment and a note for the balance of the sales price. For this transaction, paragraph 54 of Statement 66 specifies a minimum required initial investment of 15 percent of the sales value. Party B pledges the 100 percent interest in the property as security for the note to Party A; no debt is outstanding on the property.

Under paragraph 9 of Statement 66, only the 10 percent cash down payment of Party B would be included as part of the buyer's initial investment. Paragraph 11 of Statement 66 states that the initial investment should "be adequate to demonstrate the buyer's commitment to pay for the property and shall indicate a reasonable likelihood that the seller will collect the receivable."

The issues are:

1. Whether the buyer's ownership interest in a purchased property that is pledged as security for a note should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method
2. If so, in other situations in which a note is collateralized by assets other than the purchased property (for example, other real estate properties or marketable securities), whether those assets should be included as part of the buyer's initial investment in determining whether profit may be recognized under the full accrual method.

The Task Force reached a consensus that Statement 66 precludes profit recognition under the full accrual method for this transaction because purchased property or other assets pledged as security for a note should not be included as part of the buyer's initial investment.

36. FASB Emerging Issues Task Force Issue No. 88-24, *Effects of Various Forms of Financing under FASB Statement No. 66* provides the following guidance on how profit should be recognized under FASB Statement No. 66:

**ISSUE**

The sale of real estate often involves significant financing relative to the sales price. That financing may be provided by independent third parties, the seller, or both. The financing may involve a nonrecourse mortgage (that is, the lender's only recourse upon default of the buyer is to repossess the underlying real estate) and it may involve the buyer's assumption of preexisting recourse or nonrecourse mortgage obligations of the seller.

Paragraph 3 of Statement 66 provides that profit shall be recognized in full when real estate is sold, provided (1) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (2) the earnings process is virtually complete, that is, the seller is not obligated to perform significant activities after the sale to earn the profit. Paragraph 4 of Statement 66 states that collectibility of the sales price is demonstrated by the buyer's commitment to pay, which in turn is supported by substantial initial and continuing investments that give the buyer a stake in the property sufficient that the risk of loss through default motivates the buyer to honor its obligation to the seller. If the full profit is not recognized, Statement 66 requires use of the installment, cost recovery, or reduced-profit recognition methods in certain circumstances.

The issue is how profit should be recognized under Statement 66 when a real estate sales transaction involves various forms of financing.
EITF DISCUSSION

Modifying a previous consensus on this issue, the Task Force reached a consensus that the following guidelines should be applied by the seller to real estate sales transactions. (The requirements for the consummation of a real estate sales transaction and the appropriate accounting when some common forms of continuing involvement exist appear in paragraphs 6 and 25-43, respectively, of Statement 66 and are not affected by this consensus.)

1. The initial and continuing investment requirements for the full accrual method of profit recognition of Statement 66 are applicable unless the seller receives as the full sales value of the property (a) cash, without any seller contingent liability on any debt on the property incurred or assumed by the buyer, (b) the buyer's assumption of the seller's existing nonrecourse debt on the property, (c) the buyer's assumption of all recourse debt on the property with the complete release of the seller from those obligations, or (d) any combination of such cash and debt assumption. When the seller has unconditionally received all amounts it is entitled to from the sale and is not at risk related to the financing, the buyer's commitment to pay for the property is not a factor in the seller's recognition of profit.

2. To recognize profit by the full accrual method, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness shall not be included as part of the buyer's initial investment. A sufficient amount of the buyer's own cash or other qualifying forms of investment demonstrates the buyer's commitment to pay for the property; however, the buyer's borrowing secured by the property does not demonstrate such a commitment. Paragraphs 9 and 10 of Statement 66 provide additional guidance on what are included in and excluded from initial investment.

3. Under the installment, cost recovery, and reduced-profit recognition methods, debt incurred by the buyer that is secured by the property, whether incurred directly from the seller or other parties or indirectly through assumption, and payments to the seller from the proceeds of such indebtedness are not considered buyer's cash payments. However, if the profit deferred under the applicable method exceeds the outstanding amount of seller financing and the outstanding amount of buyer's debt secured by the property for which the seller is contingently liable, the seller shall recognize the excess in income.

Exhibit 88-24A presents examples of the application of this consensus.

STATUS

No further EITF Discussion is planned

37. FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, provides the following guidance:

INTRODUCTION

1. This Statement establishes accounting standard for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and for long-lived assets and certain identifiable intangibles to be disposed of.

2. Long-lived assets such as plant and equipment generally are recorded at cost, which is usually fair value at the date of acquisition. The original cost usually is reduced over time by depreciation (amortization) so that the cost to the asset is allocated to the periods in which the asset is used. That practice has been modified in some circumstances when an assets has been determined to be impaired, in which case the asset has been written down to a new carrying amount that is less than the remaining cost and a loss has been recognized. Accounting standards generally have not addressed when impairment losses should be recognized or how impairment losses should be measured. As a result, practice has been diverse.
SCOPE

3. This Statement applies to long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used and to long-lived assets and certain identifiable intangibles to be disposed of. The Statement applies to all entities. This Statement does not apply to financial instruments, long-term customer relationships of financial institution (for example, core deposit intangibles and credit cardholder intangibles), mortgage and other servicing rights, deferred policy acquisition costs, or deferred tax assets.

Assets to Be Held and Used

Recognition and Measurement of Impairment

4. An entity shall review long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

5. The following are examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed:

   a. A significant decrease in the market value of an asset
   b. A significant change in the extent or manner in which an asset is used or a significant physical change in an asset
   c. A significant adverse change in legal factors or in the business climate that could affect the value of an asset or an adverse action or assessment by a regulator
   d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
   e. A current period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with an asset used for the purpose of producing revenue.

6. If the examples of events or changes in circumstances set forth in paragraph 5 are present or if other events or changes in circumstances indicate that the carrying amount of an asset that an entity expects to hold and use may not be recoverable, the entity shall estimate the future cash flows expected to result from the use of the asset and its eventual disposition. Future cash flows are the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, the entity shall recognize an impairment loss in accordance with this Statement. Otherwise, an impairment loss shall not be recognized; however, a review of depreciation policies may be appropriate.\(^1\)

\(^1\) Paragraph 10 of APB Opinion No. 20, Accounting Changes, addresses the accounting for changes in depreciation estimates, and paragraph 32 addresses the accounting for changes in the method of depreciation. Whenever there is reason to assess the recoverability of the carrying amount of an asset under paragraphs 4 and 5 of this Statement, there may be reason to review the depreciation estimates and method under paragraphs 10 and 32 of Opinion 20. However, an impairment loss that results from applying this Statement should be recognized prior to performing that review. The provisions of Opinion 20 apply to the reporting of changes in the depreciation estimates and method regardless of whether an impairment loss is recognized under paragraph 6 of this Statement.

7. An impairment loss recognized in accordance with paragraph 6 shall be measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of an asset is the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis
for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

8. In estimating expected future cash flows for determining whether an asset is impaired (paragraph 6), and if expected future cash flows are used in measuring assets that are impaired (paragraph 7), assets shall be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

9. Estimates of expected future cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing estimates of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

10. In limited circumstances, the test specified in paragraph 6 will be applicable at only the entity level because the asset being tested for recoverability does not have identifiable cash flows that are largely independent of other asset groupings. In those instances, if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of this Statement. If the asset is expected to provide service potential, an impairment loss shall be recognized if the sum of the expected future cash flows (undiscounted and without interest charges) for the entity is less than the carrying amounts of the entity's assets covered by this Statement.

11. After an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For a depreciable asset, the new cost shall be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

Goodwill

12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as “income from operations,” entities that present such a subtotal must include the impairment loss in that subtotal.
14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment
   b. The amount of the impairment loss and how fair value was determined
   c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement
   d. If applicable, the business segment(s) affected.

Recognition and Measurement

15. APB Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, requires that certain assets to be disposed of be measured at the lower of carrying amount or net realizable value. All long-lived assets and certain identifiable intangibles to be disposed of that are not covered by that Opinion and for which management, having the authority to approve the action, has committed to a plan to dispose of the assets, whether by sale or abandonment, shall be reported at the lower of carrying amount or fair value less cost to sell. The fair value of the assets to be disposed of shall be measured in accordance with paragraph 7 of this Statement.

Paragraphs 13-16 of Opinion 30 prescribe the accounting for the disposal of a segment of a business. Paragraph 13 defines a segment of a business as “a component of an entity whose activities represent a separate major line of business or class of customer.” Paragraph 15 of that Opinion prescribes the determination of a gain or loss on the disposal of a segment of a business and states:

In the unusual circumstance, it would be expected that the plan of disposal would be carried out within a period of one year from the measurement date and that such projections of operating income or loss would not cover a period exceeding approximately one year.

16. Cost to sell an asset to be disposed of generally includes the incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Costs generally excluded from cost to sell an asset to be disposed of include insurance, security services, utility expenses, and other costs of protecting or maintaining an asset. However, if a contractual agreement for the sale of an asset obligates an entity to incur costs in the future to effect the ultimate sale, those costs shall be included as adjustments to the cost to sell an asset to be disposed of. If the fair value of an asset is measured by the current market value or by using the current selling price for a similar asset, that fair value shall be considered to be a current amount and that fair value and cost to sell shall not be discounted. If the fair value of an asset is measured by discounting expected future cash flows and if the sale is expected to occur beyond one year, the cost to sell also shall be discounted. Assets to be disposed of covered by this Statement shall not be depreciated (amortized) while they are held for disposal.

17. Subsequent revisions in estimates of fair value less cost to sell shall be reported as adjustments to the carrying amount of an asset to be disposed of, provided that the carrying amount of the asset does not exceed the carrying amount (acquisition cost or other basis less accumulated depreciation or amortization) of the asset before an adjustment was made to reflect the decision to dispose of the asset.

Reporting and Disclosure

18. An entity that holds assets to be disposed of that are accounted for in accordance with paragraphs 15-17 of this Statement shall report gains or losses resulting from the application of those paragraphs as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit...
organization. Although entities are not required to report a subtotal such as “income from operations,” entities that present such a subtotal must include the gains or losses resulting from the application of paragraphs 15-17 in that subtotal.

19. An entity that accounts for assets to be disposed of in accordance with paragraphs 15-17 shall disclose all of the following in financial statements that include a period during which those assets are held:

   a. A description of assets to be disposed of, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of those assets
   b. If applicable, the business segment(s) in which assets to be disposed of are held
   c. The loss, if any, resulting from the application of paragraph 15 of this Statement
   d. The gain or loss, if any, resulting from changes in the carrying amounts of assets to be disposed of that arises from application of paragraph 17 of this Statement
   e. The caption in the income statement or statement of activities in which the gains or losses in (c) and (d) are aggregated if those gains or losses have not been presented as a separate caption or reported parenthetically on the face of the statement
   f. The results of operations for assets to be disposed of to the extent that those results are included in the entity's results of operations for the period and can be identified.

OTHER RELEVANT INFORMATION:

38. The NAIC Technical Resource Group Proposed Draft Life Codification contains proposed revisions to Chapter 4, *Real Estate*, primarily related to statement value and requiring recognition of permanent impairments on real estate investments and adoption of the provisions of FAS 66 for accounting for sales of real estate. Certain other insignificant changes were also made in the text. Sections which contain proposed changes are as follows:

   Authorization and Limitations

   Often, statutes and regulations promulgated by the states include limitations on holding investments in real property. These limitations may include provisions requiring the disposal of foreclosed properties within a certain period of time.

   Market Value

   Market value is the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale—the buyer and seller acting prudently and knowledgeably with the price not affected by any undue stimulus. Estimates of market value are determined by a qualified real estate appraiser.

   Appraised Value

   An appraisal is an opinion of estimated market value for an adequately described property, as of a specified date, supported by the analysis of relevant data. To arrive at this value, three methods are typically used:

   1. Market Data Approach - a comparative analysis of current sales prices of similar properties, after making necessary and reasonable adjustments for any difference in the properties.

   2. Cost Approach - an estimated value based on the cost of reproduction or replacement of the improvements, less depreciation, plus the value of the land. (Land value is usually determined by the market data approach.)

   3. Income Approach - an estimated value based on the capitalization of income and productivity. It is concerned with the present value of future income future cash flows.
Statement Value

The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual cost, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company. If home office or investment real estate has been permanently impaired, the asset value must be reduced and a realized loss recorded. If the impairment on the properties is other than permanent, the property is valued at depreciated cost and no loss needs to be recognized. Real estate is considered permanently impaired when caused by obsolescence or condemnation as opposed to temporarily impaired which is caused by temporary market conditions which are expected to reverse themselves. Implicit within the designation “temporarily impaired” is the ability and intent to hold the real estate until such conditions are rectified.

Properties acquired in satisfaction of debt which are held for investment, should be transferred at the lower of cost or current market value, as determined by a qualified appraiser, to the investment real estate category.

The value of the investment real estate and property classified as property acquired in satisfaction of debt may not exceed the lower of current market value as determined by a qualified appraiser or cost balance transferred from mortgage loan plus capitalized improvements, less normal depreciation. A realized loss is recognized if there is a permanent decrease in the market value of the property subsequent to the date of acquisition. If the decline in value is considered temporary an unrealized loss is recognized. In lieu of writing down investment real estate or taking part of the value as nonadmitted when market value is less than book value, an insurer may establish a reserve for specific properties as a contra-asset. This contra-asset is a specific reserve in addition to the general reserve established under the Asset Valuation Reserve.

Income Derived from Real Estate

Income on real estate usually is received periodically and in advance. Any amount not received at the end of an accounting period should be set up as investment income due and unpaid to the extent that the amount applies to that accounting period. If the collectibility of unpaid rent is in doubt, or if the amount due exceeds a three month period, the entire amount must be nonadmitted. Rental income paid in advance of the accounting period for which it is payable in whole or in part must be included in the liability for unearned investment income to the extent it applies to the succeeding accounting period. If rental income is to be received over a period shorter than the full lease period, the total rent to be received must be accrued periodically as if the rent were received over the total lease period. Interest expense on a mortgage is netted against the investment income for the period.

Sale of Real Estate

Life insurance companies must follow Statement of Financial Accounting Standards (FASB) No. 66 in determining whether a sale has taken place, whether all requirements have been met to recognize profit under the full accrual method, and, if not appropriate, which method of profit recognition should be followed: the deposit, installment or cost recovery method.

Sale of retail land must be accounted for under provisions of FASB #66: (1) by the full accrual method, (2) by the percentage-of-completion method, (3) by the installment sales method, or (4) by the deposit method.

Sale-leaseback transactions involving real estate must be accounted for under the provisions of FASB #98. A sale-leaseback transaction is one in which an owner sells the property and leases back the same property from the purchaser.
A company can recognize the sale of any real estate that it owns as an immediate cash sale or as a contract of sale. In a sale for cash and/or mortgage, title transfers to the buyer when the sale is consummated. Any profit or loss on the sale is considered to be realized in the year of sale. In a sale involving an installment contract, often referred to as land contracts, title is retained by the seller and transferred to the buyer only when he has paid the entire sales price, or a substantial portion of it.

If the sale of real estate, including real estate occupied by the Company, includes a mortgage or other note from the Company, some states may require the transaction be reported as a financing transaction using the deposit method of accounting for sale-leaseback transaction.

An insurer does not take credit for any profit from the sale or exchange of its assets when the consideration received and otherwise properly reported as an admitted asset is in the form of an installment contract, unless such profit is fully reserved by a liability established which is equal to the portion of such profit which is unrealized. In computing the realized portion of the profit on installment contracts, payments are allocated at the rate the principal is reduced by said payments.

39. The draft discussion material from previous Property/Casualty codification projects proposed changes to Chapter 4, *Real Estate*, primarily removing the option to establish a reserve for specific properties in lieu of writing down or nonadmitting part of the investment real estate balance when market value is less than book value. In addition, it provides guidance on how to determine whether a decrease in market value has occurred and how a writedown would be recorded. Sections which contain proposed revisions are provided below:

**Statement Value**

The statement value of all real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvements, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

The value of all other real estate (investment real estate and property acquired in satisfaction of debt) may not exceed the lower of (a) current market value, or (b) cost plus capitalized improvements less normal depreciation. When market value is less than book value, insurers shall either: (a) write down book value to market value, or (b) nonadmit the excess of book value over market value.

(If determining whether a decrease in the market value of investment real estate has occurred, the net income derived from each investment should be divided by an appropriate capitalization rate, and compared to the book value. If the result of this calculation is less than book value for two consecutive years, there would be a presumption that a decrease in value had occurred, which would indicate that a new appraisal of the real estate is appropriate.)

If the book value is to be written down, it would be recorded as a Decrease by Adjustment in Book Value on Schedule A, carried forward to Part 1A as a Decrease by Adjustment in Book Value, and recorded as an unrealized capital loss on the Underwriting and Investment Exhibit. If the excess value is to be nonadmitted, the aggregate nonadmitted amount for all real estate would be recorded on Exhibit 1, and recorded as a change in nonadmitted assets on the Underwriting and Investment Exhibit.

**Sale of Real Estate**

A company may sell real estate for cash (and/or a mortgage), or as an installment sale. In a sale for cash (and/or mortgage), where title transfers to the buyer as part of the consummated transaction, any profit or loss on the sale shall be reported in the year of sale. Under installment
contracts, the seller retains title until all or a substantial portion of payments have been made. The Seller shall recognize a profit on the sale (under a pro rata method) only to the extent that payments have been received. If the seller records the entire profit at the commencement of the contract, it shall establish a reserve to offset the portion of profits which are unrealized (i.e., not yet paid by the buyer). Losses on installment sales shall be recognized immediately. An insurer may elect to use an accounting method that is more conservative in its recognition of gains, such as the cost-recovery method or the deposit method if the facts of the situation so indicate.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate, and Chapter 22, General Expenses and Taxes, Licenses and Fees
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 4, Real Estate, Chapter 19, Expenses, and Appendix A, Mortgage Guaranty Insurance Accounting Principles
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 22 - Leases
- Issue Paper No. 23 - Property Occupied by the Company
- Issue Paper No. 36 - Troubled Debt Restructurings
- Issue Paper No. 38 - Acquisition, Development and Construction Arrangements
- Issue Paper No. 44 - Capitalization of Interest
- Issue Paper No. 68 - Business Combinations and Goodwill

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 66, Accounting for Sales of Real Estate
- FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects
- FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, “Chapter 10, Taxes, Section A-Real Estate and Personal Property Taxes
- AICPA Statement of Position 92-1, Accounting for Real Estate Syndication Income
- AICPA Statement of Position 92-3, Accounting for Foreclosed Assets
- FASB Emerging Issues Task Force No. 84-17, Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages or Insured Mortgages
- FASB Emerging Issues Task Force Issue No. 86-6, Antispeculation Clauses in Real Estate Sales Contracts
- FASB Emerging Issues Task Force Issue No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds
- FASB Emerging Issues Task Force Issue No. 87-29, Exchange of Real Estate Involving Boot
- FASB Emerging Issues Task Force Issue No. 88-12, Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66
- FASB Emerging Issues Task Force Issue No. 88-24, Effects of Various Forms of Financing under FASB Statement No. 66
- FASB Emerging Issues Task Force No 89-13, Accounting for the Cost of Asbestos Removal
- FASB Emerging Issues Task Force No. 89-14, Valuation of Repossessed Real Estate
- FASB Emerging Issues Task Force No. 90-8, Capitalization of Costs to Treat Environmental Contamination

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**State Regulations**
- Minnesota regulations - 60A.122 and 60A.123
- Missouri regulations 20 CSR 200-13.100
- Arizona Statutes - Insurance Laws, TITLE 20
- Nevada Statutes - Insurance Laws, TITLE 57

**Other Sources of Information**
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 4, Real Estate
- Draft discussion material from previous Property/Casualty codification projects, Chapter 4, Real Estate
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Statutory Issue Paper No. 41

Surplus Notes

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Reporting entities sometimes issue instruments that have the characteristics of both debt and equity. These instruments are commonly referred to as surplus notes, the term used herein, but are also referred to as surplus debentures or contribution certificates. These instruments are used for various reasons, including but not limited to:

   a. Providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations.

   b. Providing a source of capital to mutual and other types of non-stock reporting entities who do not have access to traditional equity markets for capital needs.

   c. Providing alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.

Common attributes of surplus notes are that they are only allowable pursuant to the approval of the domiciliary state, the form and content require regulatory approval and interest may be paid and principal may be repaid only with the prior approval of the commissioner of the state of domicile.

2. Current statutory guidance allows that surplus notes may be reported as surplus and not as debt of the reporting entity. Statutory guidance for issuers of surplus notes is found in Chapter 27, Paid-in or Contributed Capital and Organizational Surplus, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and Chapter 24, Paid-in or Contributed Capital and Organizational Surplus of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Statutory guidance for holders of surplus notes is provided in Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures). GAAP does not distinguish surplus notes from other types of subordinated notes and requires them to be recorded as liabilities.

3. The purpose of this issue paper is to establish statutory accounting principles for issuers of surplus notes and holders of surplus notes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Issuers of Surplus Notes

4. Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved as to form and content shall be reported as surplus and not as debt only if the surplus note contains the following provisions:

   a. Subordination to policyholders;
b. Subordination to claimant and beneficiary claims;
c. Subordination to all other classes of creditors other than surplus note holders; and
d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

The proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.

5. Costs of issuing surplus notes (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Accordingly, such costs shall be charged to operations when incurred.

6. Discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be charged or credited to the statement of operations concurrent with approved interest payments on the surplus note and in the same proportion or percentage as the approved interest payment is to the total estimated interest to be paid on the surplus note.

7. Interest shall be not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest:
   a. Shall not be reported through operations;
   b. Shall not be represented as an addition to the principal or notional amount of the instrument; and
   c. Shall not accrue further interest, i.e., interest on interest.

8. As of the date of approval of principal repayment by the commissioner of the state of domicile, the issuer shall reclassify such approved payments from surplus to liabilities.

Disclosures
9. The notes to the financial statements of a reporting entity that issues surplus notes shall disclose the following as long as the surplus notes are outstanding:
   a. Date issued,
   b. Description of the assets received,
   c. Holder of the note or if public the names of the underwriter and trustee,
   d. Amount of note,
   e. Carrying value of note,
   f. The rate at which interest accrues,
   g. Maturity dates or repayment schedules, if stated,
   h. Unapproved interest and/or principal,
Surplus Notes

i. Interest and/or principal paid in the current year,

j. Total interest and/or principal paid on surplus notes,

k. Subordination terms,

l. Liquidation preference to the reporting entity’s common and preferred shareholders and

m. The repayment conditions and restrictions.

In addition to the above a reporting entity shall identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to rule 144A under the Securities Act of 1933), and any holder of 10% or more of the outstanding amount of any surplus note registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders of Surplus Notes

10. Surplus notes meet the definition of an asset as defined in Issue Paper No. 4. Holders of surplus notes shall follow SVO valuation procedures. The valuation procedures documented in the SVO Purposes and Procedures are detailed in paragraph 17 of this issue paper. Surplus notes shall be accounted for in accordance with Issue Paper No. 26 - Bonds, excluding Loan-backed andStructured Securities (Issue Paper No. 26). The admitted asset value of a surplus note shall not exceed the amount that would be admitted if the instrument was considered an equity instrument and added to any other equity investments in the issuer held directly or indirectly by the holder of the surplus note. Only interest that has been approved by the issuer’s domiciliary commissioner shall be accrued as income by a holder of surplus notes in a manner consistent with Issue Paper No. 26.

DISCUSSION

11. The primary concern of regulators is the ability of a reporting entity to meet its obligations to its policyholders. Additionally, surplus notes are subordinated to policyholder, claimant and beneficiary claims, as well as debts owed to all other classes of creditors (other than surplus note holders). For these reasons, they are viewed as surplus by regulators. A reporting entity’s ability to pay interest and repay principal on surplus notes is more restrictive than its ability to pay dividends on common stock since most states permit some level of dividends to be paid without prior approval of the commissioner. The restrictive nature and the level of regulatory control over surplus notes coupled with the requirement of surplus notes to be reviewed as to form and content (including approval of the assets received for the surplus notes) provides assurances that adequate surplus exists to meet policyholder obligations.

12. The conclusions reached in this issue paper are consistent with current statutory guidance which requires surplus notes to be reported as surplus. Reporting surplus notes as surplus is consistent with the objectives of statutory financial reporting outlined in the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.
Existing statutory guidance has been expanded by this issue paper to address the accounting for issuance costs of these instruments and to require the disclosure of unapproved principal, principal paid in the current year and total principal paid on surplus notes. These disclosures are parallel to disclosures required for interest.

13. The conclusions reached in this issue paper vary from GAAP which requires all debt instruments, including surplus notes, to be recorded as liabilities. GAAP does not have the concept of surplus but rather has the concept of stockholders’ equity. Stockholders’ equity is a measure of the amount of net assets available to stockholders after all other obligations have been satisfied. As a contrast to features of surplus notes that make them policyholders’ surplus, certain preferred stocks issued by entities have redemption features or liquidation preferences that provide their holders more favorable treatment than is provided to holders of common stock. GAAP has tended to focus on disclosure of those features and liquidation preferences. The Securities and Exchange Commission has issued guidance that requires equity securities with debt like features, such as mandatorily redeemable preferred stock to be recorded outside of the equity section of the balance sheet because of their liability-like characteristics.

14. Under GAAP, holders of surplus notes are required to account for such investments either at amortized cost or market value depending on their ability and intent with respect to holding the securities to maturity. FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115) has been rejected in its entirety in Issue Paper No. 26, Issue Paper No. 28 - Short-term Investments, Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 32 - Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities) and Issue Paper No. 43 - Loan-backed and Structured Securities.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
Issuers
15. Chapter 24 of the P&C Accounting Practices and Procedures Manual and Chapter 27 of the Life/A&H Accounting Practices and Procedures manual provide the following guidance:

Subordinated Surplus Debentures and Other Similar Instruments

Insurers sometimes issue instruments that have the characteristics of both debt and equity. These instruments resemble debt inasmuch as they are repayable at interest and sometimes, dependent on the requirements of the domiciliary jurisdiction, include maturity dates and/or schedules of repayment. However, key provisions make these instruments tantamount to equity. These provisions are that they are allowable pursuant to the domiciliary jurisdiction’s statutory, or other regulatory provisions, approval requirements as to form and content and most importantly, interest may be paid and principal may be repaid only with the prior approval of the commissioner of the domiciliary jurisdiction. These instruments are sometimes referred to by other names including “surplus debentures”, “contribution certificates”, or “capital notes”.

This type of funding shall not be used to initially capitalize an insurer other than a mutual or reciprocal insurer. However, this type of instrument provides regulators with flexibility in dealing with problem situations to attract capital to companies whose surplus levels are deemed inadequate to support an insurer’s operations. It is noted that various jurisdictions’ dividend limitations based on “earned surplus” inhibit possible investors from providing necessary surplus funding. Additionally, mutual and other types of non-stock insurers do not have access to the other forms of capital equity markets.
As noted in the various states’ statutes that specifically provide for these types of instruments, these instruments may be reported as surplus and not as debt. This is due to the strict control which inures to the commissioners of those jurisdictions regarding the form and content of the instrument and the payment of interest and the repayment of principal.

The proceeds from this type of surplus acquisition must be in the form of cash, cash equivalents, or other assets having a readily determinable value satisfactory to the domiciliary commissioner. Insurers must clearly report the transaction in its “Notes to the Financial Statements” including the fact that payment of interest and repayment of principal is subject to the domiciliary jurisdiction’s approval.

Interest on such instruments is to be reported as an expense and a liability only after payment has been approved. Accrued interest that has not been approved for payment:

1. should not be reported through operations;
2. should not be represented as an addition to the instrument; and,
3. may not accrue further interest, i.e., “interest on interest”.

The amount of the accrued unapproved interest should be reflected in the “Notes to the Financial Statements”.

When a domiciliary jurisdiction grants an insurer permission to report a surplus note instrument as a component of its surplus account, the surplus note document shall provide that in the event of liquidation, the claims under the instrument are subordinated to policyholder, claimant and beneficiary claims as well as debts owed to all other classes of creditors (creditors other than surplus note holder) and that all payment of principal and interest are not payable and shall not be paid until approved by the domiciliary commissioner. The claims of the holder of a surplus note may be superior to claims of the issuer’s common and preferred shareholders if so provided in the instrument itself and duly authorized by the issuer. Such conditions shall also be clearly reported in the “Notes to the Financial Statements”.

This section applies to all such above described instruments issued after the date of adoption (December 12, 1991).

16. NAIC Annual Statement Instructions contain the following guidance with respect to disclosure of surplus notes:

6. Capital and Surplus and Shareholders’ and Policyholders’ Dividend Restrictions

Instruction:

e. For each surplus debenture or similar obligation, except those surplus notes required or which are a prerequisite for purchasing an insurance policy and are held by the policyholder, included on Page 3, Line 24A, furnish the following information: date issued, interest rate, amount of note, carrying value (lower of amortized cost or market value), interest paid current year, total interest paid, accrued interest and date of maturity.

f. For each surplus debenture or similar obligation included in 6e, other than a surplus debenture which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

• the name of the holder (indicate if parent or affiliate);
• description of the assets received; and
• the repayment conditions and restrictions.
For each surplus debenture or similar obligation included in 6e which is issued in an offering registered under the Securities Act of 1933 or distributed in an underwritten offering pursuant to Rule 144A under the Securities Act of 1933, furnish:

- the name of the underwriters (indicate if parent or affiliate);
- the name of the registrar/paying agent (indicate if parent or affiliate);
- the description of the assets received; and
- the repayment conditions and restrictions.

In addition to the above, identify all affiliates that hold any portion of a surplus debenture or similar obligation (including an offering registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933), and any holder of ten percent (10%) or more of the outstanding amount of any surplus debenture registered under the Securities Act of 1933 or distributed pursuant to Rule 144A under the Securities Act of 1933.

Holders
17. The SVO Purposes and Procedures provides the following guidance with respect to investments in surplus notes:

**Section 7: Procedures for Valuing Surplus Debentures**

(A) An insurance company that owns surplus debenture(s) (notes) issued by another insurance company shall value the surplus debenture(s) as follows:

1. At amortized cost if the notes have been rated by a Nationally Recognized Statistical Rating Organization (NRSRO) and have a NAIC rating equivalent designation of 1. If the notes have been rated by more than one NRSRO, the lowest rating equivalent shall be used for purposes of this valuation procedure.

2. Notes that are not rated or have a NAIC rating equivalent designation of 2 through 6 shall be valued as follows:

   a. At its outstanding face value, notwithstanding the payment of interest and/or principal, when the notes were issued by an insurer whose capital and surplus (excluding the Asset Valuation Reserve and all surplus notes) is greater than or equal to the greater of 5% of its admitted assets (excluding separate accounts) or $6,000,000. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

   b. By applying the statement value factor to the outstanding face amount of the surplus notes, notwithstanding the payment of interest and/or principal, when the notes were issued by an insurer whose capital and surplus (excluding the Asset Valuation Reserve and all surplus notes) is less than the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000. The statement value factor is equal to total capital and surplus, including surplus notes, less the greater of 5% of admitted assets (excluding separate accounts) or $6,000,000 divided by the surplus notes. The valuation should be calculated using the most recently filed statutory financial statement of the insurer that issued the notes;

3. At zero, notwithstanding any previous payments of interest and/or principal, when the notes are issued by an insurer which is subject to any order of liquidation, conservation, rehabilitation or a company action level event based on its risk-based capital.
Issuers of surplus debentures must obtain the latest rating letters from the NRSROs who rate their notes and file them with the Executive Director of the SVO semiannually on June 1 and December 1 of each year. If there is a change in the rating, the SVO should be notified immediately.

Surplus debenture(s) must not be valued in excess of the lesser of the value determined above or amortized cost and are to be reported in Schedule BA of the annual statement as other invested assets. For life insurers, the NRSRO rating equivalent may be used to report the surplus note statement value in the fixed income category of the other invested assets maximum reserve calculation. The maximum reserve factor should be the factors used for preferred-stocks not bonds. If no rating from a NRSRO exists, the surplus notes should be reserved on line 43 of the other invested asset maximum reserve calculation. This procedure is effective for all financial statements filed as of December 31, 1994, and thereafter.

(B) Issuers whose Surplus Notes are eligible for amortized value accounting by Holders pursuant to Section 7 (A). To be included on this list insurer holders or issuers must request listing and supply copies of appropriate NRSRO rating documents.

- Farmers Insurance Exchange
- General American Life Ins. Co.
- John Hancock Mutual Life Ins. Co.
- Massachusetts Mutual Life Ins. Co.
- Liberty Mutual Ins. Co.
- Metropolitan Life Ins. Co.
- National Life Ins. Co.
- Nationwide Mutual Ins. Co.
- New York Life Ins. Co.
- Ohio National Life Ins. Co.
- Pacific Mutual Life Ins. Co.
- Principal Mutual Life Ins. Co.
- Prudential Insurance Company of America

18. Chapter 9 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance for holders of surplus notes:

**Surplus Notes:**

Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as “surplus notes”, “surplus debentures”, “contribution certificates”, “capital notes”, etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer’s domiciliary commissioner.

**Generally Accepted Accounting Principles**

19. The distinction between a liability and equity instrument in GAAP is found in FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* (only pertinent excerpts are included):
55. Although the line between equity and liabilities is clear in concept, it may be obscured in practice. Applying the definitions to particular situations may involve practical problems because several kinds of securities issued by business enterprises seem to have characteristics of both liabilities and equity in varying degrees or because the names given some securities may not accurately describe their essential characteristics. For example, convertible debt instruments have both liability and residual-interest characteristics, which may create problems in accounting for them. (APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, and APB Opinion No. 15, Earnings per Share, both discuss problems of that kind.) Preferred stock also often has both debt and equity characteristics, and some preferred stocks may effectively have maturity amounts and dates at which they must be redeemed for cash.

20. FAS 115 provides the following guidance with respect to investments in surplus notes:

FAS 115 Summary
Summary

This Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Those investments are to be classified in three categories and accounted for as follows:

- Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders’ equity.

This Statement does not apply to unsecuritized loans. However, after mortgage loans are converted to mortgage-backed securities, they are subject to its provisions. This Statement supersedes FASB Statement No. 12, Accounting for Certain Marketable Securities, and related Interpretations and amends FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, to eliminate mortgage-backed securities from its scope.

OTHER SOURCES OF INFORMATION

21. Article 5 of Regulation S-X of the Securities and Exchange Commission provides the following pertinent guidance:

Redeemable Preferred Stocks

28. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. (a) Include under this caption amounts applicable to any class of stock which has any of the following characteristics: (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates whether by operation of a sinking fund or otherwise; (2) it is redeemable at the option of the holder; or (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under §210.5-02.29 unless it meets one or more of the above criteria.

(b) State on the face of the balance sheet the title of each issue, the carrying amounts and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares
subscribed but unissued, and show the deduction of subscriptions receivable therefrom. If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below. Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate [See §210.4-071]

(c) State in a separate note captioned “Redeemable Preferred Stocks” (1) a general description of each issue, including its redemption features (e.g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made; (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and (3) the changes in each issue for each period for which an income statement is required to be filed. [See also § 210.4-08(d).]

(d) Securities reported under this caption are not to be included under a general heading “stockholders’ equity” or combined in a total with items described in captions 29, 30 or 31 which follow.

Non-Redeemable Preferred Stocks
29. Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. State on the face of the balance sheet, or if more than one issue is outstanding state in a note, the title of each issue and the dollar amount thereof. Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. State on the face of the balance sheet or in a note, for each issue, the number of shares authorized and the number of shares issued or outstanding as appropriate [See § 210.4-071. Show in a note or separate statement the changes in each class of preferred shares reported under this caption for each period for which an income statement is required to be filed. [See also § 210.4-08(d).

Common Stocks
30. Common stocks. For each class of common shares state, on the face of the balance sheet, the number of shares issued or outstanding, as appropriate [see §210.4 07] and the dollar amount thereof. If convertible, this fact should be indicated on the face of the balance sheet. For each class of common shares state, on the face of the balance sheet or in a note, the title of the issue, the number of shares authorized, and, if convertible, the basis of conversion [see also § 210.4-08(d)]. Show also the dollar amount of any common shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom. Show in a note or statement the changes in each class of common shares for each period for which an income statement is required to be filed.

RELEVANT LITERATURE

Statutory Accounting
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement instructions
- The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 26 - Bonds, excluding Loan-Backed and Structured Securities

**Generally Accepted Accounting Principles**
- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- Article 5 of Regulation S-X of the Securities and Exchange Commission
Statutory Issue Paper No. 42

Sale of Premium Receivables

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on the transfer or factoring of premium receivables with recourse is limited to the guidance provided in minutes of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group). GAAP accounting provides guidance on accounting for sales of receivables with recourse. The purpose of this issue paper is to establish statutory accounting principles for the sale or factoring of premium receivables that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. For purposes of this issue paper, receivables shall only include amounts due to the reporting entity for premium receivables (uncollected premium, agent's balance receivables and bills receivables). As used in this paper, receivables do not represent amounts due to the reporting entity generated by the sale of invested assets.

3. A transfer of receivables can take the form of a transfer with recourse or a transfer without recourse:
   a. Recourse shall be defined as the right of a transferee of receivables to receive payment from the transferor of those receivables for (i) failure of the debtors to pay when due, (ii) the effects of prepayments, or (iii) adjustments resulting from defects in the eligibility of the transferred receivables, for example defects in the legal title of the transferred receivables. When the transferor has the right to repurchase (“call”) or the transferee has the right to require the transferor to repurchase (a “put”) the transferred receivables, the transfer shall be considered to have recourse.
   b. Without recourse shall be defined as the transferor surrendering all of the future economic implications of the risks and rewards embodied in the transferred receivables.

4. A transfer of receivables with recourse shall not be recognized as a sale. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received.

5. If a transfer qualifies to be recognized as a sale, the difference between (a) the sales price and (b) the receivables transferred shall be recognized as a gain or loss. If receivables are sold with servicing retained and the stated servicing fee is less than a current (normal) servicing fee rate (a servicing fee rate that is representative of servicing fee rates most commonly used in comparable servicing agreements covering similar types of receivables) or no servicing fee is specified, the gain or loss recognized by the sale of receivables shall be adjusted to recognize the deviation of the stated servicing fee rate from the commonly used servicing fee rate and a liability shall be established to provide for a normal servicing fee in each subsequent servicing period, which shall not be less than the estimated servicing costs. When the
stated servicing fee is greater than a normal servicing fee the gain or loss shall not be adjusted and the excess servicing fee revenues shall not be recorded currently but shall be recorded when realized.

6. If the conditions of subparagraph 3b. are not met, or the transfer is for other than cash, the receivables shall remain on the transferor's financial statements. A liability shall be established in an amount equal to the greater of the carrying amount of the receivables transferred or the amount of the proceeds received. To the extent that the proceeds received are less than the carrying amount of receivables transferred, a loss shall be recorded. The carrying amount of the receivable balance shall be evaluated at each reporting period and adjusted for any uncollectible amounts. The liability shall be relieved as the transferee receives cash. When the proceeds received are greater than the receivables transferred the liability shall be relieved on a pro rata basis as the receivables are collected.

Disclosures
7. For transfers of receivables reported as sales, the transferor's financial statements shall disclose (a) the proceeds to the transferor and (b) the gain or loss recorded on the sale.

DISCUSSION
8. The conclusion above rejects paragraph 83 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) to the extent that it permits sales recognition for sales of receivables with recourse provisions.

9. Deferring the recognition of a gain for transfers of receivables which do not meet the criteria in subparagraph 3b. or are for other than cash is consistent with the conservatism concept in the Statement of Concepts. In addition, it prevents the recognition of income before the earnings process is completed as prescribed in the recognition concept of the Statement of Concepts. The receipt of cash for the transfer of receivables that were either admitted assets or non-admitted assets when there are no recourse provisions involved represents a completed transaction and as such the receivable is deemed to have been collected.

Drafting Notes/Comments
- Securitization of investments is addressed in Issue Paper No. 86 – Securitization.
- Reinsurance receivables are addressed in Issue Paper No. 75 – Property and Casualty Reinsurance.
- Related party transactions are addressed in Issue Paper No. 25 – Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
10. Current statutory accounting guidance on the sale or factoring of premium receivables with recourse is limited to the guidance provided in the June 10, 1991 minutes of the Emerging Accounting Issues Working Group. This guidance relates to the accounting for “Intercompany Related Receivable Sales”. The minutes provide guidance as follows: “The working group concluded that, in most instances, this type of transaction should be treated as a loan or financing arrangement and FAS 77 should be used for guidance, particularly as it may relate to affiliates and also to transactions between affiliates.”

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes of the June 10, 1991 meeting
Generally Accepted Accounting Principles
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 43

Loan-backed and Structured Securities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in loan-backed and structured securities is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also establishes the NAIC’s Securities Valuation Office (SVO) as the primary authority for the valuation of such investments.

2. The purpose of this issue paper is to establish statutory accounting principles for investments in loan-backed and structured securities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Loan-backed securities shall be defined as pass-through certificates, collateralized mortgage obligations (CMOs) and other “securitized” loans not included in structured securities, as defined below, for which the payment of interest and/or principal is directly proportional to the interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Structured securities shall be defined as loan-backed securities which have been divided into two or more classes for which the payment of interest and/or principal of any class of securities has been allocated in a manner which is not proportional to interest and/or principal received by the issuer from the mortgage pool or other underlying securities. Loan-backed securities and structured securities are collectively referred to as loan-backed securities in this issue paper.

4. Loan-backed securities meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

5. The acquisitions and dispositions of loan-backed securities shall be recorded on the trade date. At acquisition, loan-backed securities shall be reported at their cost, including brokerage and related fees. For securities where all information is not known as of the trade date (i.e., actual payment factors, specific pools, etc.), a reporting entity shall make its best estimate based on known facts.

6. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses on sales of loan-backed securities shall be in accordance with Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses on sales of loan-backed securities shall be recorded on the trade date, and shall be reported on the net realized gains or losses line of the Investment Income section of the Statement of Operations.

Origination Fees

7. Origination fees represent fees charged to the borrower in connection with the process of originating or restructuring a transaction. The fees include, but are not limited to, points, management,
arrangement, placement, application, underwriting, and other fees pursuant to such a transaction. Origination fees shall not be recorded until received in cash. Origination fees intended to compensate the reporting entity for interest rate risks (e.g., points), shall be amortized into income over the term of the loan-backed security consistent with paragraph 11 of this issue paper. Other origination fees shall be recorded as income upon receipt.

**Origination, Acquisition, and Commitment Costs**

8. Costs related to origination when paid in the form of brokerage and other related fees shall be capitalized as part of the cost of the loan-backed security, consistent with paragraph 5 of this issue paper. All other costs, including internal costs or costs paid to an affiliated entity related to origination, purchase, or commitment to purchase loan-backed securities, shall be charged to expense when incurred.

9. Commitment fees are fees paid to the reporting entity that obligate the reporting entity to make available funds for future borrowing under a specified condition. A fee paid to the reporting entity to obtain a commitment to make funds available at some time in the future, generally, is refundable only if the loan-backed security is issued. If the loan-backed security is not issued then the fees shall be recorded as investment income by the reporting entity when the commitment expires.

10. A fee paid to the reporting entity to obtain a commitment to borrow funds at a specified rate and with specified terms quoted in the commitment agreement, generally, is not refundable unless the commitment is refused by the reporting entity. This type of fee shall be deferred, and amortization shall depend on whether or not the commitment is exercised. If the commitment is exercised, then the fee shall be amortized in accordance with paragraph 11 of this issue paper over the life of the loan-backed security as an adjustment to the investment income on the loan-backed security. If the commitment expires unexercised, the commitment fee shall be recognized in income on the commitment expiration date.

**Amortized Cost**

11. The purchase discount or premium shall be amortized using the interest method as an adjustment to investment income. The interest method results in a constant effective yield equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments to book value. The amortization period shall reflect estimates of the period over which redemption of the loan-backed securities is expected to occur, not the stated maturity period.

**Balance Sheet Amount**

12. Loan-backed securities shall be valued and reported in accordance with the NAIC Valuations of Securities manual prepared by the Securities Valuation Office. For reporting entities that maintain an Asset Valuation Reserve (AVR), the loan-backed securities shall be reported at amortized cost, except for those with an NAIC designation of 6, which shall be reported at the lower of amortized cost or market value. For reporting entities that do not maintain an AVR, loan-backed securities that are designated highest-quality and high-quality (NAIC designations 1 and 2, respectively) shall be reported at amortized cost; with all other loan-backed securities (NAIC designations 3 to 6) reported at the lower of amortized cost or market value.

**Changes in Valuation**

13. Changes in prepayment assumptions and the resulting cash flows shall be reviewed periodically. For securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments, such review shall be performed quarterly. Examples of securities that have the potential for loss of a portion of the original investment include CMO residuals and mortgage-backed interest-only certificates. For such securities, an effective yield or internal rate of return is calculated at acquisition based on the purchase price and anticipated future cash flows. For other investments, such review may be performed annually. The prepayment rates of the underlying loans shall
be used to determine prepayment assumptions. Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Reporting entities should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each reporting entity may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry. Relevant sources and rationale used to determine prepayment assumptions should be documented by the reporting entity.

14. Loan-backed securities shall be revalued using the new prepayment assumptions using either the prospective or retrospective adjustment methodologies, as defined in paragraph 31, consistently applied by type of securities. The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under this method, the recalculated effective yield will equate the carrying amount of the investment to the present value of the anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for subsequent accounting periods. There are no accounting changes in the current period unless the undiscounted anticipated cash flow is less than the carrying amount of the investment. The retrospective methodology changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance is then increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

**Impairment**

15. Regardless of whether a reporting entity is using a prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative yield (undiscounted estimated future cash flows are less than the current book value), an other than temporary impairment shall be considered to have occurred. Accordingly, the cost basis of the loan-backed security shall be written down to the undiscounted estimated future cash flows and the amount of the write down shall be accounted for as a realized loss (which shall be included in IMR). The new cost basis shall not be changed for subsequent recoveries in fair value. Therefore the prospective adjustment method must be utilized for periods subsequent to the loss recognition.

**Income**

16. Interest shall be accrued using the interest method using the redemption prices and redemption dates used for amortizing premiums and discounts. Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of loan-backed securities, and the addition of discount accrual. Contingent interest may be accrued if the applicable provisions of the underlying contract and the prerequisite conditions have been met.

17. A loan-backed security may provide for a prepayment penalty or acceleration fee in the event the investment is liquidated prior to its scheduled termination date. Such fees shall be reported as investment income when received.
Loaned Loan-Backed Securities
18. When loan-backed securities are loaned, they remain either admitted or nonadmitted assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the securities. When collateral is provided and it is deposited for the general use of the reporting entity, it becomes either an admitted or nonadmitted asset of the reporting entity based on its characteristics, and a liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned securities.

Wash Sales
19. When investments in loan-backed securities are sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales, and shall be accounted for as sales and disclosed as required by paragraph 25. Unless there is a concurrent contract to repurchase or redeem the transferred security from the transferee, the transferor does not maintain effective control over the security.

Giantization/Megatization of FHLMC or FNMA Mortgage Backed Securities
20. Giantization/megatization of mortgage backed securities is defined as existing pools of FHLMC or FNMA mortgage-backed securities (MBS) with like coupon and prefix which are repooled together by the issuing agency creating a new larger security. The new Fannie Mae “Mega” or Freddie Mac “Giant” is a guaranteed MBS pass-through representing an undivided interest in the underlying pools of loans.

21. The benefits derived from giantization/megatization include:

   a. Increased liquidity: Smaller MBS pools (particularly those with current face of less than $1 million) are less liquid than mortgage pools with current faces exceeding $5 million. Repooling smaller MBS pools into one, larger pool improves the marketability for the aggregate package;

   b. Geographic diversity: Regrouping of multiple pools generally will create greater geographic pool loan diversity resulting in less prepayment variation due to regional economic factors;

   c. Reduced administrative expenses: The reduced number of pools lowers bank custodial fees, pricing/factor service fees, and increases efficiency for the accounting and investment departments.

22. Repooled FHLMC and FNMA securities meet the definition of substantially the same as defined in Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (Issue Paper No. 45). The transaction shall not be considered a sale/purchase and no gain or loss shall be recognized. To properly document the repooling, the transaction shall be reported through Schedule D of the Annual Statement as a disposition and an acquisition.

23. Transaction fees charged by the issuing agencies shall be capitalized and amortized over the life of the repooled security.
Disclosures
24. In addition to the disclosures required for invested assets in general, reporting entities shall disclose the following about their loan-backed securities in the notes to the financial statements:

   a. Fair values in accordance with Issue Paper No. 33 - Disclosures about Fair Value of Financial Instruments

   b. Concentrations of credit risk in accordance with Issue Paper No. 27 - Disclosure of Information about Financial Instruments with Concentration of Credit Risk

   c. Basis at which the loan-backed securities are stated

   d. The adjustment methodology used for each type of security (prospective or retrospective)

   e. Changes from the retrospective to the prospective adjustment methodology due to negative yield on specific securities.

   f. If a reporting entity elects to use book value as of January 1, 1994 as the cost, for securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, that fact shall be disclosed.

   g. Descriptions of sources used to determine prepayment assumptions

   h. Market value sources (The following sources shall be applied consistently 1) public market quotes, 2) fair value provided by the broker, 3) management estimate, 4) pricing service, 5) pricing matrix).

   i. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral and a description, including the amount, of loaned securities.

25. Reporting entities shall disclose the following information for wash sales, as defined in paragraph 19, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

   a. A description of the reporting entity’s objectives regarding these transactions;

   b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

   c. The number of transactions involved during the reporting period;

   d. The book value of securities sold;

   e. The cost of securities repurchased;

   f. The realized gains/losses associated with the securities involved.

DISCUSSION
26. The statutory accounting principles described in the summary conclusion section adopt current statutory accounting guidance, for loan-backed securities, contained in paragraph 32 (which becomes fully effective for 1995), except as follows:
a. Paragraph 5 requires loan-backed securities acquisitions and dispositions to be recorded on the trade date, whereas current statutory guidance is silent.

b. Paragraph 19 provides guidance on wash sales of loan-backed securities.

c. Paragraph 40 provides guidance concerning the criteria which constitutes what are the same or substantially the same investments as defined in conjunction with dollar repurchase agreements. Due to the similarities between the investments discussed herein and the investments which underlie dollar repurchase agreements, the utilization of the same criteria to define “the same and substantially the same” investments appears reasonable and consistent.

27. This issue paper rejects the GAAP guidance for loan-backed securities, which is contained in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115), FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (FAS 91), FASB Emerging Issues Task Force No. 89-4, Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, FASB Emerging Issues Task Force No. 90-2, Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security, FASB Emerging Issues Task Force No. 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, and FASB Emerging Issues Task Force No. 96-12, Recognition of Interest Income and Balance Sheet Classification of Structured Notes. The primary differences between the statutory accounting principles established in this issue paper and GAAP are as follows:

a. FAS 115 requires investments in debt securities to be classified into three categories: held-to-maturity, available-for-sale and trading. Held-to-maturity securities are reported at amortized cost. Available-for-sale are reported at fair value, with unrealized gains or losses reported as a separate component of shareholders' equity. Trading securities are reported at fair value, with unrealized gains or losses included in earnings.

b. GAAP does not require reporting of AVR.

c. FAS 91 and EITF 89-4 require that (1) for other than high-risk loan-backed securities, adjustments to the effective yield be for changes in prepayment assumptions be made on a retrospective basis; (2) for high-risk CMOs, such adjustments be made on a prospective basis.

d. FAS 91 allows deferral of certain origination costs.

e. Under this issue paper, impairment is measured based on nondiscounted estimated cash flows. Emerging Issues Task Force Issue No. FASB 93-18, Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate. (EITF 93-18) requires that impairment be measured based on discounted cash flows.

28. This issue paper adopts paragraphs 9 through 12, 15, 17, 23 through 31 and 61 through 65 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) as they relate to loan-backed securities. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities.

29. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the
transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the
transaction shall be accounted for by the transferor as a sale of the “loaned” securities.

30. AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of
Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3) is consistent
with paragraph 35 of this issue paper and has been adopted in Issue Paper No. 45.

31. The statutory accounting principles established in this issue paper attempt to smooth the effect
upon a reporting entity’s surplus of fair value fluctuation of investments held by the reporting entity. This
is consistent with the Statement of Concepts which states that “conservative valuation procedures
provide protection to policyholders against adverse fluctuations in financial condition or operating
results.” Statutory accounting principles for life insurance companies also use the concept of AVR and
Interest Maintenance Reserve (IMR) adjustments to compensate for fair value fluctuations over time.

Drafting Notes/Comments
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due
  and Accrued.
- Accounting for AVR and IMR is addressed in Issue Paper No. 7 - Asset Valuation Reserve and
  Interest Maintenance Reserve.
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities addresses accounting
  for bonds.
- Special purpose subsidiaries used to securitize loans are addressed in Issue Paper No. 86 -
  Securitization. That issue paper addresses the situation whereby a reporting entity securitizes loans
  through the special purpose entity, and then purchases the resultant securities as investments

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
32. Chapter 1, Bonds and Loaned Backed and Structured Securities, in the Accounting Practices and
Procedures Manual for Life and Accident and Health Insurance Companies contains the following
guidance relating to loan-backed and structured securities:

ACCOUNTING FOR LOAN-BACKED AND STRUCTURED SECURITIES (CMOs)

Description

Loan-backed and structured securities are financial instruments designed to channel funds from
capital markets to mortgage borrowers. The investments are structured so that all or substantially
all of the collections of principal and interest from the underlying collateral are paid through to the
investor.

Loan-backed securities are defined as pass-through certificates, collateralized mortgage
obligations (CMOs) and other securitized loans not included in structured securities as defined in
the next paragraph. The payment of interest and/or principal on loan-backed securities is directly
proportional to the interest and/or principal received by the issuer from the mortgage pool or other
underlying securities.

Structured securities are defined as loan-backed securities which have been divided into two or
more classes, where the payment of interest and/or principal of any class of the securities has
been allocated in a manner which is not proportional to interest and/or principal received by the
issuer from the mortgage pool or underlying securities. Structured securities have been further
defined as collateralized mortgage obligations and other structured securities for Schedule D
reporting and disclosures.
These investments are issued by special-purpose corporations or trusts (issuer) established by a sponsoring parent organization. Mortgage loans or other securities securing the loan-backed obligation are acquired by the issuer and pledged to an independent trustee until the issuer's obligation has been fully satisfied. The investor can look only to the issuer's assets (primarily the trusteed assets or third parties such as insurers or guarantors) for repayment of the obligation. As a result, the sponsor and its other affiliates may have no financial obligation under the instrument, although one of those entities may retain the responsibility for servicing the underlying mortgage loans. Some sponsors do guarantee the performance of the underlying loans.

At purchase, loan-backed and structured securities are recorded at purchase cost. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value.

Prepayment Assumptions

Prepayments are a significant variable element in the cash flow of the investment because they affect the yield and determine the expected maturity against which the yield is evaluated. Falling interest rates generate faster prepayment of the mortgages underlying the security, shortening its duration. This causes the insurance company to reinvest assets much sooner than expected at potentially less advantageous rates. This is called prepayment risk. Extension risk is created by rising interest rates which slow repayment and can significantly lengthen the duration of the security.

Because performance of these securities is highly sensitive to prepayment rates, assumptions must be reviewed at least annually. Assumptions used for securities that have the potential for loss of a portion of the original investment due to changes in interest rates or prepayments should be reviewed quarterly. Changes in prepayment assumptions and the resulting cash flows must be considered when determining the carrying value of the security in periods after purchase.

Securities should be revalued using the new prepayment assumptions resulting from the annual or quarterly review. The effective yield is calculated using anticipated cash flows of the security based on an assumption of prepayment rates of the underlying loans. Variable rate securities or floaters, should use a constant rate of interest determined at the date of the calculation.

Prepayment assumptions should be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). Companies should also use consistent assumptions across portfolios for similar collateral within controlled affiliated groups. Since each company may have a unique method for determining the prepayment assumptions, it is impractical to set standard assumptions for the industry.

Relevant sources and rationale used to determine prepayment assumptions should be documented by the company.

Adjustment Methodologies

Both the prospective and retrospective adjustment methodologies are acceptable when revaluing these investments. The methods require that the effective yield be recalculated at each reporting date if there has been a change in the underlying assumptions. A company or a controlled affiliated group must choose a method for each type of security and consistently apply it to the security type. A security type describes the principal payment and interest payment
characteristics of the security. For structured securities, the issuing agencies have developed a set of standard definitions for REMIC and CMO bonds describing principal and interest payment types.

Prospective Method

The prospective approach recognizes, through the recalculation of the effective yield to be applied to future periods, the effects of all past cash flows whose amounts differ from those estimated earlier and the effects and changes in projected cash flows. Under this method, the recalculated effective yield will equate the carrying amount of the investment to the present value of anticipated future cash flows. The recalculated yield is then used to accrue income on the investment balance for the subsequent accounting period. No change in the carrying amount is required to be recognized unless the undiscounted anticipated cash flow is less than the carrying amount of the investment.

Retrospective Method

The retrospective method changes both the yield and the asset balance so that expected future cash flows produce a return on the investment equal to the return now expected over the life of the investment as measured from the date of acquisition. Under the retrospective method, the recalculated effective yield will equate the present value of the actual and anticipated cash flows with the original cost of the investment. The current balance of the investment is increased or decreased to the amount that would have resulted had the revised yield been applied since inception, and investment income is correspondingly decreased or increased.

Under this method, the adjustment to book value to recognize premium or discount on payments that differed from estimates is called a true-up. Since it is an adjustment to yield, the offset to the book value is a charge or credit to investment income.

Negative Yield

Using either the prospective or retrospective method, if the revaluation based on new prepayment assumptions results in a negative effective yield (estimated future cash flows are less than the current book value), the security should be valued at the undiscounted estimate of anticipated future cash flows. Writedowns representing a loss in value should be treated as a realized capital loss and included in the IMR. The loss should be amortized over the weighted average life consistent with the valuation of the security at the time of the loss recognition.

At the time of recognition, a new cost basis should be established for the security. In future periods, the security cannot be written up and therefore the prospective adjustment methodology must be used for periods subsequent to the loss recognition.

A company should be able to identify those securities for which a negative yield adjustment was taken.

Investment Limitations

Loan-backed securities including CMOs and other structured securities may be subject to limitations established by the state of domicile.

Effective Date

The guidance in this chapter is effective for the year ending December 31, 1994 for loan-backed and structured securities that have the potential for loss of a portion of the original investment, such as losses arising from changes in interest rates or prepayments rates. (These securities should include, but are not limited to, interest-only structured securities and structured securities
purchased at a significant premium over par value.) These accounting and reporting principles are effective for all loan-backed and structured securities for the year ending December 31, 1995. Companies may adopt compliance earlier, if desired.

For securities purchased prior to January 1, 1994 where historical cash flows are not readily available for applying the retrospective method, the company may use January 1, 1994 as the acquisition date and the then book value as the cost for purposes of determining yield adjustments in future periods. If this option is selected, a company should disclose that fact in the footnote where it presents the amortization methods used.


34. The SVO Purposes and Procedures - Section 2 - Procedures for Determining NAIC Designations for Bonds contains guidance on loan-backed securities. Pertinent excerpts are as follows:

(1) Collateralized Obligations. The ability of any type of collateral to enhance or fully support the contractual provisions of any security will be taken into account by the SVO only if acceptable documentary evidence is provided. This might include, but is not limited to the filing of the SVO's Collateral Loan form where appropriate, the original due diligence package, appraisal reports, valuations of business entities reports or any other relevant supporting information.

(18) Loan-backed and Structured Securities. The SVO encourages insurers to obtain ratings for loan-backed and structured securities submitted for an NAIC designation from an NAIC approved NRSRO. For unrated structured securities acquired by conversion i.e., securitization, refer to Section 6(B)(g)(i) for instructions.

(E) Instructions for Completing Schedule D of the NAIC Annual Statement

The following table indicates the appropriate entries to be made in Schedule D of the NAIC Annual Statement for all bonds except income bonds (see Section 2(C)(1)) and perpetual bonds and demand notes (see Section 2(C)(2)).

<table>
<thead>
<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>AMORTIZED OR INVESTMENT MARKET VALUE COLUMNS</th>
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<tbody>
<tr>
<td>1</td>
<td>Amortized Cost</td>
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<td>SVO</td>
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<tr>
<td>2</td>
<td>Amortized Cost</td>
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<td></td>
<td>Market Rate</td>
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<td></td>
<td>Par Value X Rate</td>
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<td></td>
<td>or</td>
</tr>
<tr>
<td>3</td>
<td>Amortized Cost</td>
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<tr>
<td></td>
<td>Amortized Cost</td>
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<td>or</td>
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<td></td>
<td>if No Rate</td>
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<tr>
<td>4</td>
<td>Amortized Cost</td>
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<tr>
<td></td>
<td>A.V.</td>
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<td></td>
<td>Available</td>
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<tr>
<td>5</td>
<td>Amortized Cost</td>
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<td></td>
<td>if No Rate</td>
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<td>6</td>
<td>The lesser of the</td>
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<td>Market Value Amount</td>
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<td>or Amortized Cost</td>
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<td>Par Value times</td>
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<td>Market Rate</td>
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</table>

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.
(2) For Property and Casualty Insurers and All Other Insurers Not Maintaining an Asset Valuation Reserve (AVR)

<table>
<thead>
<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>AMORTIZED OR INVESTMENT VALUE COLUMN</th>
<th>MARKET VALUE COLUMNS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Amortized Cost</td>
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<td>2</td>
<td>Amortized Cost</td>
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<tr>
<td>3</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Cost or Par Value</td>
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<td>X Rate</td>
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<td>4</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Cost or Par Value</td>
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<td>X Rate</td>
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<td>5</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
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<td>X Rate</td>
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<tr>
<td>6</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Cost or Par Value</td>
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<td></td>
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<td>X Rate</td>
</tr>
</tbody>
</table>

A.V. = Bond has been valued at amortized value and that value should appear in the Market Value Amount Column.

35. Chapter 1, Bonds and Loan Backed and Structured Securities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, contains the following guidance concerning the criteria which constitutes investments which are “the same or substantially the same” for dollar repurchase agreements:

- a. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency, thereof, in which case the guarantor must be the same.
- b. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.
- c. The mortgage-backed securities must bear the identical contractual interest rate.
- d. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
- e. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- f. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5 percent (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is $1,000,000, the principal amount of mortgage-backed securities reacquired must be between $1,025,000 and $975,000 to qualify under this criterion.
Generally Accepted Accounting Principles

36. GAAP guidance is promulgated by FAS 115. Pertinent excerpts are as follows:

Accounting for Certain Investments in Debt and Equity Securities

6. At acquisition, an enterprise shall classify debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. At each reporting date, the appropriateness of the classification shall be reassessed.

Held-to-Maturity Securities

7. Investments in debt securities shall be classified as held-to-maturity and measured at amortized cost in the statement of financial position only if the reporting enterprise has the positive intent and ability to hold those securities to maturity.

Trading Securities and Available-for-Sale Securities

12. Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. Mortgage-backed securities that are held for sale in conjunction with mortgage banking activities, as described in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, shall be classified as trading securities. (Other mortgage-backed securities not held for sale in conjunction with mortgage banking activities shall be classified based on the criteria in this paragraph and paragraph 7.)

b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.

Reporting Changes in Fair Value

13. Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109, Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

14. Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.
Impairment of Securities

16. For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

4 A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, Accounting for Noncurrent Marketable Equity Securities.

37. FAS 91 provides the following guidance:

Purchase of a Loan or Group of Loans

15. The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred.

Application of the Interest Method and Other Amortization Matters

18. Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. Under the provisions of this Statement, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

6 The “interest” method is also described in paragraph 16 of APB Opinion No. 12, Omnibus Opinion--1967, in the first sentence of paragraph 15 of APB Opinion No. 21, Interest on Receivables and Payables, and in paragraphs 235-239 of FASB Concepts Statement No. 6, Elements of Financial Statements.
a. If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (Refer to Appendix B.)

b. If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (Refer to Appendix B.)

c. The loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate (LIBOR), or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. ⑦ (Refer to Appendix B.)

⑦ A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of paragraphs 18(a) and (b).

19. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. If the enterprise holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the enterprise may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. If the enterprise anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the enterprise shall recalculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans shall be adjusted to the new balance with a corresponding charge or credit to interest income. Enterprises that anticipate prepayments shall disclose that policy and the significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans shall no longer be acceptable. (Refer to Appendix B.)

38. EITF 89-4 provides the following guidance:

Emerging Issues Task Force 89-4 Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-only Certificate.
ISSUE

Collateralized mortgage obligations and certain participating interests in real estate mortgage investment conduits (REMICs) (hereinafter collectively referred to as CMOs) are typically issued by a special-purpose entity (the issuer). The issuer may be organized in a variety of legal forms, such as a trust, a corporation, or a partnership. Accordingly, an investor may purchase a CMO instrument in equity form (for example, trust interests, stock, or partnership interests) or nonequity form (for example, participating debt securities). CMOs are collateralized by mortgage loans or mortgage-backed securities that are transferred to the CMO trust or pool by a sponsor. The issuer is structured so that collections from the underlying collateral provide the cash flow to make principal and interest payments on the obligations, or tranches, of the issuer.

Some CMO instruments, regardless of legal form, are most like debt instruments because those CMO instruments have stated principal amounts and traditional defined interest rate terms. Purchasers of certain other CMO instruments are entitled to the excess, if any, of the issuer's cash inflows, including reinvestment earnings, over the cash outflows for debt service and administrative expenses. Those CMO instruments, regardless of legal form, may include instruments designated as residual interests and are "high-risk" in that these CMO instruments could result in the loss of a portion of the original investment.

When accounting for a purchased investment in a CMO, the issues are:

1. Which factors (legal form, economic substance, or other factors) should be considered in determining whether to account for CMO instruments as equity or nonequity

2. What attribute(s) of nonequity high-risk CMO instruments and mortgage-backed interest-only certificates distinguishes them as a group of instruments that should be accounted for similarly

3. How an investment in a nonequity high-risk CMO instrument or in a mortgage-backed interest-only certificate should be accounted for in subsequent periods; specifically, how current and expected future cash flows should be allocated between income and return of investment in each accounting period.

EITF DISCUSSION

The Task Force reached a consensus as follows:

Issue 1

The Task Force reached a consensus that the accounting for a purchased investment in a CMO instrument should generally be consistent with the form of the investment. However, some CMO instruments issued in the form of equity represent solely the purchase of a stream of future cash flows to be collected under preset terms and conditions. Consequently, a purchased investment in a CMO instrument in equity form meeting all of the following criteria is required to be accounted for as a nonequity investment regardless of the legal form of the instrument (for example, beneficial interest in a trust, common stock, or partnership interest):

1. The assets in the special-purpose entity were not transferred to the special-purpose entity by the purchaser of the CMO instrument. ¹
1 An investor in a CMO instrument who transferred assets to the related special-purpose entity should follow the accounting established by Statement 77 or Technical Bulletin 85-2, as applicable.

2. The assets of the special-purpose entity consist solely of a large number of similar high-credit-quality monetary assets (or one or more high-credit-quality mortgage-backed securities that provide an undivided interest in a large number of similar mortgage loans) for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

2 High-credit-quality monetary assets as used herein include only (1) assets guaranteed by the U.S. government, its agencies, or other creditworthy guarantors and (2) mortgage loans or mortgage-backed securities sufficiently collateralized to ensure that the possibility of credit loss is remote.

3. The special-purpose entity is self-liquidating, that is, it will terminate when the existing assets are fully collected and the existing obligations of the special-purpose entity are fully paid.

4. Assets collateralizing the obligations of the special-purpose entity may not be exchanged, sold, or otherwise managed as a portfolio, and the purchaser has neither the right nor the obligation to substitute assets that collateralize the entity's obligations.

5. There is no more than a remote possibility that the purchaser would be required to contribute funds to the special-purpose entity to pay administrative expenses or other costs.

6. No other obligee of the special-purpose entity has recourse to the purchaser of the investment.

The ability of a purchaser of a CMO instrument to call other CMO tranches of the special-purpose entity generally will not preclude treatment of the purchaser's investment as a nonequity instrument provided all the above criteria are met.

CMO instruments issued in the form of equity that do not meet the above criteria should be accounted for under the provisions of Opinion 18 or ARB 51, as amended by Statement 94.

Issue 2

The Task Force reached a consensus that nonequity CMO instruments that have potential for loss of a significant portion of the original investment due to changes in (1) interest rates, (2) the prepayment rate of the assets of the CMO structure, or (3) earnings from the temporary reinvestment of cash collected by the CMO structure but not yet distributed to the holders of its obligations (reinvestment earnings) are high-risk CMO instruments and should be accounted for as described in Issue 3 below. Nonequity CMO instruments include all CMO instruments issued in debt form and those CMO instruments issued in equity form that meet all six criteria listed in Issue 1.

For example, most issuers of CMO obligations have excess cash flows each period after required bond payments and administrative costs have been paid. Typically, the excess cash flows arise primarily from the spread between the interest rate paid on the CMO obligations and the interest rate received on the issuer's assets. The issuer may sell nonequity instruments (often called
CMO residuals) that entitle the purchaser to these excess cash flows. These instruments often have little or no principal component. If mortgage prepayments increase or if the interest rate paid on variable-rate obligations of the issuer increases, or both, the total cash flow to the investor in the CMO residual would significantly decline, possibly leaving the investor unable to recover a significant portion of the initial purchase price. Therefore, these types of CMO instruments are high-risk CMO instruments.

Other mortgage-related instruments entitle an investor to receive cash flows designated as interest from specified mortgages or mortgage-backed securities. These instruments are often called interest-only certificates and are similar to high-risk nonequity CMO instruments due to the potential for loss related to prepayment risk. The Task Force also reached a consensus that mortgage-backed interest-only certificates should be accounted for in the same manner as high-risk nonequity CMO instruments (see Issue 3 below).

Nonequity CMO instruments that do not have the potential for loss of a significant portion of the original investment due to the factors enumerated above, such as principal-only certificates, are not high-risk CMO instruments. Premiums and discounts arising from the purchase of CMO instruments that are not high risk should be amortized in accordance with the provisions of Statement 91.

Issue 3

The Task Force reached a consensus that in accounting for each purchased high-risk nonequity CMO instrument for which it is appropriate to use amortized cost, the investor should allocate the total cash flows expected to be received over the estimated life of the investment between principal and interest in the following manner. [Note: See STATUS section.] At the date of purchase, an effective yield is calculated based on the purchase price and anticipated future cash flows. In the initial accounting period, interest income is accrued on the investment balance using that rate. Cash received on the investment is first applied to accrued interest with any excess reducing the recorded investment balance. At each reporting date, the effective yield is recalculated based on the amortized cost of the investment and the then-current estimate of future cash flows. This recalculated yield is then used to accrue interest income on the investment balance in the subsequent accounting period. This procedure continues until all cash flows from the investment have been received.

The amortized balance of the investment at the end of each period will equal the present value of the estimated future cash flows discounted at the newly calculated effective yield.

The estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments. Prepayment estimates should be made using assumptions that are consistent with assumptions used by marketplace participants for similar instruments, which the Task Force understands may require the use of an estimate of future interest rates implied by the current yield curve. In addition, if future cash flows will be directly affected by changes in interest rates, current interest rates at or near the balance sheet date should be used to estimate those cash flows. Estimates of cash flows from reinvestment earnings also should be based on rates that are not in excess of current interest rates for eligible investments as defined in the CMO instrument.

\[3\] For example, some CMO instruments have cash flows that are impacted by the interest paid to variable-rate tranche holders in the same CMO structure. Current rates should be used to estimate the amounts to be paid to the variable rate tranche holders and in turn the amount of future cash flows to be collected from the CMO instruments.
Investors in high-risk CMO instruments should evaluate each CMO instrument separately to determine whether expected future cash flows are adequate to recover the recorded investment balance. The recorded balance for each investment should not exceed the undiscounted estimated future cash flows; that is, the effective yield cannot be negative. Any write-down establishes a new cost, which then is used for purposes of calculating effective yields in subsequent periods.

If investments in high-risk CMO instruments are significant, the effective yield calculated at the reporting date, which will be used to accrue income in the following period, should be disclosed in the annual financial statements. Either the effective yield for each CMO instrument or the effective yield for the portfolio of CMO instruments may be disclosed. If significant, the carrying amount and fair value of investments in high-risk CMO instruments also should be disclosed in the annual financial statements. When market quotations are not available for these investments, estimates should be made.

The application of this consensus is limited to circumstances in which the CMO or similar instrument represents an interest in a pool of high-credit-quality monetary assets for which prepayments are probable and the timing and amounts of prepayments can be reasonably estimated.

This consensus supersedes the conclusions expressed by the Task Force in Issue No. 86-38, “Implications of Mortgage Prepayments on Amortization of Servicing Rights,” Subissue C, “Unanticipated Prepayments and Interest-Only Certificates,” with respect to interest-only certificates.

General Comments

The SEC Observer noted that the method of adopting the consensuses should be disclosed. If adoption of the consensuses materially affects comparability, the nature and effect of adoption (including a quantification of the effects, if practicable) also should be disclosed in the notes to the financial statements.

The SEC Observer expressed concern that the accounting prescribed by these consensuses might be analogized to similar investments in collateralized borrowing structures when (1) the underlying collateral is of a lesser credit quality than that defined in this consensus or (2) the cash flow from the underlying collateral cannot be reasonably estimated. The SEC staff believes that such investments should be accounted for following a conservative method that adequately reflects the nature of those high-risk structures.

The Task Force noted that some CMO instruments and interest-only certificates are economically similar to excess servicing receivables and other mortgage-related investments. Diverse accounting methods for amortizing investments in the various types of mortgage-related instruments have been established in accounting literature. In addition, different interpretations of existing literature have resulted in further diversity in practice. The Task Force acknowledged the need for more comprehensive guidance in this area and authorized the working group to submit a letter to the FASB encouraging the Board to establish uniform guidance through a short-term project separate from the financial instruments project. [Note: See STATUS section.]

STATUS

The methodologies for amortizing and adjusting the carrying value of excess servicing fee assets and investments in interest-only securities or other similar financial instruments will be considered by the FASB staff as part of the project on present-value-based measurements.
In May 1993, the FASB issued Statement 115, which addresses accounting for certain investments in debt and equity securities and supersedes Statement 12. Under Statement 115, a positive intent and ability to hold a debt security to maturity is a prerequisite for using amortized cost. A financial institution must consider whether it has the ability to hold a high-risk CMO instrument to maturity under existing regulatory requirements. (See Topic No. D-39 in Appendix D.)

Paragraph 16 of Statement 115 states that if the decline in fair value of a security is judged to be other than temporary, the cost basis of the individual security should be written down to fair value. That measure of impairment differs from the measure in Issue 3 of the Task Force's consensus. In Issue No. 93-18, "Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate," the Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.

Issue 93-18 also addresses whether Statement 115 changes the consensus on Issue 89-4 with respect to the timing of recognizing impairment of investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates. The Task Force decided to supersede that aspect of the consensus on Issue 89-4 with a new consensus that if the present value of estimated future cash flows discounted at a risk-free rate is less than the amortized cost basis of the instrument, an impairment loss should be recognized.

No further EITF discussion is planned.

39. EITF 93-18 provides the following guidance:

Emerging Issued Task Force 93-18 Impairment Recognition for a purchased Investment in a Collateralized Mortgage obligation Instrument or in a Mortgage-Bond Interest-only Certificate

ISSUE

Paragraph 16 of Statement 115 requires that if a decline in fair value of an individual security classified as either available-for-sale or held-to-maturity is judged to be other than temporary, the cost basis shall be written down to fair value. The measure of an impairment loss for the securities discussed in Issue No. 89-4, “Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,” was based on undiscounted future cash flows. The recognition of an impairment loss under Issue 89-4 occurs when the recalculated effective yield turns negative (that is, when the sum of the newly estimated undiscounted future cash inflows is less than the security's recorded balance) and the impairment recognized was a write-down such that the recalculated effective yield was zero.

The issues are (1) whether Statement 115 changes the measure of an impairment loss for those instruments addressed in Issue 89-4 (that is, investments in high-risk nonequity collateralized mortgage obligation instruments and interest-only certificates), (2) whether Statement 115 changes the consensus on Issue 89-4 about the timing for recognition of an impairment loss for those instruments, and (3) whether previously recognized impairment losses for those instruments should be remeasured at fair value for purposes of determining the cumulative catch-up adjustment upon initial adoption of Statement 115.

EITF DISCUSSION

The Task Force reached a consensus that Statement 115 changes the measure of impairment of the instruments addressed in Issue 89-4 from undiscounted cash flows to fair value.
The Task Force also reached a consensus that if the present value of estimated future cash flows discounted at a risk-free rate (that is, the rate on monetary assets that are essentially risk free, as described in paragraph 4 of Statement 76) is less than the amortized cost basis of the instrument, an impairment loss should be recognized. That comparison should be made at each reporting date. The excess of the amortized cost basis over the instrument's fair value should be recognized as a realized loss in the income statement, thereby establishing a new cost basis for the security. The rate to be used to determine the present value amount is the risk-free rate for instruments with duration consistent with the security's estimated future cash flows at the time the instrument is tested for impairment. The term duration is used in its technical sense to mean the weighted-average time to receive all cash flows (interest, dividends, and principal), where the weights reflect the relative present values of the cash flows.

The Task Force reiterated the guidance in Issue 89-4 that the estimated future cash flows at each reporting date should reflect the most current estimate of future prepayments and use the same assumptions that are specified by the consensus in Issue 89-4.

The Task Force also reached a consensus that the amortized cost basis of those instruments that are determined to have an other-than-temporary impairment loss at the time of initial adoption of Statement 115 should be written down to fair value. The amount of the write-down should be included as part of the cumulative catch-up adjustment. If an enterprise has initially adopted Statement 115 in a reporting period prior to the period in which this consensus was reached (that is, the reporting period that includes March 24, 1994), an additional adjustment may be necessary to comply with this consensus. That adjustment, which also would be determined as of the date of initial adoption, should be reported as an additional cumulative catch-up adjustment in the reporting period that includes March 24, 1994.

These consensuses are limited to those instruments that are within the scope of Issue 89-4.

STATUS

No further EITF discussion is planned.

40. AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3) provides the following guidance:

13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.¹

¹ The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.
b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.  

2 For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary “in form and type”); commercial paper for redeemable preferred stock.

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.  

3 For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.  

4 Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

41. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:
   a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
   a. Derecognize all assets sold
   b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
   c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
   d. Recognize in earnings any gain or loss on the sale.

   The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

3 Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for
collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor’s right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Disclosures

17. An entity shall disclose the following:
   a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
   c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
   d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
   e. For all servicing assets and servicing liabilities:
      (1) The amounts of servicing assets or liabilities recognized and amortized during the period
      (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
      (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
      (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.
Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor’s competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity must meet both of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      (1) Holding title to transferred financial assets
      (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      (4) Distributing proceeds to the holders of its beneficial interests.
   b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.
7 The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.


Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:
   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
   b. Identical form and type so as to provide the same risks and rights
   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
   d. Identical contractual interest rates
   e. Similar assets as collateral
   f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

9 In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.
Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Securities Lending Transactions

FAS125, Par.61.

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferrer ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferrer typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferrer typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferrer.

FAS125, Par.62.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferrer as a sale of the "loaned" securities for proceeds consisting of the "collateral" and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferrer has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferrer have a claim only to the "collateral" and the forward repurchase commitment.

11If the "collateral" is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferrer to the transferee.

FAS125, Par.63.

63. However, many securities lending transactions are accompanied by an agreement that entities and obligates the transferrer to repurchase or redeem the transferred assets before their maturity under which the transferrer maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferrer is considered to have borrowed. Collateral provided in
securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.

FAS125, Par.64.
64. The transferor of securities being "loaned" accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

FAS125, Par.65.
65. Accounting for a securities lending transaction treated as a secured borrowing:

Facts

Transferor's carrying amount and fair value of security loaned $1,000
Cash “collateral” 1,020
Transferor's return from investing cash collateral at a 5 percent annual rate 5
Transferor's rebate to the borrower at a 4 percent annual rate 4

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

Cash 1,020
Payable under securities loan agreements 1,020
To record the receipt of cash collateral

Securities loaned to broker 1,000
Securities 1,000
To reclassify loaned securities that cannot be redeemed on short notice

Money market instrument 1,020
Cash 1,020
To record investment of cash collateral

At conclusion:

Cash 1,025
Interest 5
Money market instrument 1,020
To record results of investment

Securities 1,000
Securities loaned to broker 1,000
To record return of security
Payable under securities loan agreements 1,020
Interest ("rebate") 4
Cash 1,024
To record repayment of cash collateral plus interest

Journal Entries for the Transferee

At inception:
Receivable under securities loan agreements 1,020
Cash 1,020
To record transfer of cash collateral
Securities 1,000
Obligation to return borrowed securities 1,000
To record receipt of borrowed securities that cannot be redeemed on short notice

At conclusion:
Obligation to return borrowed securities 1,000
Securities 1,000
To record the return of securities
Cash 1,024
Receivable under securities loan agreements 1,020
Interest revenue ("rebate") 4
To record the receipt of cash collateral and rebate interest

Repurchase Agreements and “Wash Sales”

FAS125, Par.66.
FAS125, Par.69.
69. Furthermore, “wash sales” that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.
FAS125, Par.70.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 27 - Disclosure of Information about Financial Instruments with Concentrations of Credit Risk
- Issue Paper No. 33 - Disclosures about Fair Value of Financial Instruments
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

**Generally Accepted Accounting Principles**

- FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
- FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*
- FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- EITF 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- FASB Emerging Issues Task Force No. 90-2, *Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security*
- EITF 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*
- FASB Emerging Issues Task Force No. 96-12, *Recognition of Interest Income and Balance Sheet Classification of Structured Notes*
- AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*

**State Regulations**

- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 44

Capitalization of Interest

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not address capitalization of interest cost.

2. GAAP guidance allows capitalization of interest as part of the historical cost of acquiring certain assets.

3. The purpose of this issue paper is to establish statutory accounting principles for capitalization of interest cost that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Under statutory accounting principles, the historical cost of acquiring an asset generally includes the necessary costs incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset shall be included as a part of the historical cost of acquiring the asset.

5. Interest cost shall be capitalized for the following types of assets:
   a. Assets constructed or otherwise produced for an enterprise’s own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made);
   b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g. real estate developments);
   c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee’s activities include the use of funds to acquire qualifying assets for its operations. The equity method is defined in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities (Issue Paper No. 46).

6. Interest cost shall not be capitalized for the following types of assets:
   a. Assets that are in use or ready for their intended use in the earning activities of the enterprise;
   b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use;
   c. Investments accounted for by the equity method after the planned principal operations of the investee begin;
d. Investments in regulated investees that are capitalizing both the cost of debt and equity capital;

e. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose;

f. Nonadmitted assets.

7. The amount of interest cost to be capitalized for qualifying assets shall be determined in accordance with subparagraphs 12 through 16 of paragraph 14 below and subparagraph 6 of paragraph 17 below.

8. The capitalization period shall be in accordance with subparagraphs 17 through 19 of paragraph 14 below and subparagraph 7 of paragraph 17 below.

9. Disclosures shall be made in the financial statements or related notes in accordance with subparagraph 21 of paragraph 14 below.

10. Capitalized interest meets the definition of an asset defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and is an admitted asset to the extent it conforms to the requirements of this issue paper. Capitalized interest shall be assessed for impairment in conjunction with the assessment of the related asset. As outlined in paragraph 4 above, the capitalized interest is included as a part of the historical cost of acquiring the asset. Interest capitalization shall not cease when such an assessment requires recognition of a lower value for the asset than acquisition cost; rather the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

DISCUSSION

11. The statutory principles described in the conclusion above adopt the GAAP accounting principles for capitalization of interest cost set forth in FASB Statement No. 34, Capitalization of Interest Cost (FAS 34), FASB Statement No. 42, Determining Materiality for Capitalization of Interest Cost (FAS 42), FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method (FAS 58), and FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants (FAS 62), except that nonadmitted assets are ineligible for capitalization of interest.

12. The statutory accounting principles described in the conclusion above are consistent with the recognition concept in the Statement of Concepts, because capitalized interest cost represents a component of the cost of the related asset which would be recoverable and available to fulfill policyholder obligations upon sale of the asset unless an impairment exists. Pertinent excerpts follow:

Recognition

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interest should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.
Drafting Notes/Comments
- Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities, addresses the equity method for accounting for investments in subsidiaries, controlled and affiliated companies.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
13. Statutory accounting literature does not address capitalization of interest cost.

Generally Accepted Accounting Principles
14. FAS 34 provides the following guidance:

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for capitalizing interest cost as a part of the historical cost of acquiring certain assets. For the purposes of this Statement, interest cost includes interest recognized on obligations having explicit interest rates,\(^1\) interest imputed on certain types of payables in accordance with APB Opinion No. 21, Interest on Receivables and Payables, and interest related to a capital lease determined in accordance with FASB Statement No. 13, Accounting for Leases.

\(^1\) Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

2. Paragraphs 15 and 16 of Opinion 21 provide that the discount or premium that results from imputing interest for certain types of payables should be amortized as interest expense over the life of the payable and reported as such in the statement of income. Paragraph 12 of Statement 13 provides that, during the term of a capital lease, a portion of each minimum lease payment shall be recorded as interest expense. This Statement modifies Opinion 21 and Statement 13 in that the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with this Statement.

3. Some enterprises now charge all interest cost to expense when incurred; some enterprises capitalize interest cost in some circumstances; and some enterprises, primarily public utilities, also capitalize a cost for equity funds in some circumstances. This diversity of practice and an observation that an increasing number of nonutility registrants were adopting a policy of capitalizing interest led the Securities and Exchange Commission to impose, in November 1974, a moratorium on adoption or extension of such a policy by most nonutility registrants until such time as the FASB established standards in this area.\(^2\)

\(^2\) Securities and Exchange Commission, ASR No. 163, Capitalization of Interest by Companies Other Than Public Utilities (Washington: November 14, 1974).

4. Appendix A provides additional background information. Appendix B sets forth the basis for the Board’s conclusions, including alternatives considered and reasons for accepting some and rejecting others.

5. The Addendum to APB Opinion No. 2, Accounting for the ‘Investment Credit’, states that “differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the
rate-making process,” and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those operations of an enterprise that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

6. The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

___________

3 The term intended use embraces both readiness for use and readiness for sale, depending on the purpose of acquisition.

4 See paragraph 17 for a definition of those activities for purposes of this Statement.

___________

7. The objectives of capitalizing interest are (a) to obtain a measure of acquisition cost that more closely reflects the enterprise’s total investment in the asset and (b) to charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited.

8. In concept, interest cost is capitalizable for all assets that require a period of time to get them ready for their intended use (an “acquisition period”). However, in many cases, the benefit in terms of information about enterprise resources and earnings may not justify the additional accounting and administrative cost involved in providing the information. The benefit may be less than the cost because the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. In that circumstance, interest capitalization is not required by this Statement.

Assets Qualifying for Interest Capitalization

9. Subject to the provisions of paragraph 8, interest shall be capitalized for the following types of assets (“qualifying assets”):

   a. Assets that are constructed or otherwise produced for an enterprise’s own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made)

   b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., ships or real estate developments).

10. However, interest cost shall not be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis because, in the Board’s judgment, the informational benefit does not justify the cost of so doing. In addition, interest shall not be capitalized for the following types of assets:

   a. Assets that are in use or ready for their intended use in the earning activities of the enterprise

   b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use.

11. Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular
use, the expenditures to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those expenditures is a cost of acquiring the asset that results from those activities. If the resulting asset is a structure, such as a plant or a shopping center, interest capitalized on the land expenditures is part of the acquisition cost of the structure. If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land expenditures is part of the acquisition cost of the developed land.

The Amount of Interest Cost to Be Capitalized

12. The amount of interest cost to be capitalized for qualifying assets is intended to be that portion of the interest cost incurred during the assets’ acquisition periods that theoretically could have been avoided (for example, by avoiding additional borrowings or by using the funds expended for the assets to repay existing borrowings) if expenditures for the assets had not been made.

13. The amount capitalized in an accounting period shall be determined by applying an interest rate(s) (“the capitalization rate”) to the average amount of accumulated expenditures for the asset during the period. The capitalization rates used in an accounting period shall be based on the rates applicable to borrowings outstanding during the period. If an enterprise’s financing plans associate a specific new borrowing with a qualifying asset, the enterprise may use the rate on that borrowing as the capitalization rate to be applied to that portion of the average accumulated expenditures for the asset that does not exceed the amount of that borrowing. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of the enterprise.

14. In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances. For example, in some circumstances, it will be appropriate to include all borrowings of the parent company and its consolidated subsidiaries; for some multinational enterprises, it may be appropriate for each foreign subsidiary to use an average of the rates applicable to its own borrowings. However, the use of judgment in determining capitalization rates shall not circumvent the requirement that a capitalization rate be applied to all capitalized expenditures for a qualifying asset to the extent that interest cost has been incurred during an accounting period.

15. The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the enterprise in that period. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent company and consolidated subsidiaries on a consolidated basis. In any separately issued financial statements of a parent company or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intercompany borrowings) incurred by the separate entity.

16. For the purposes of this Statement, expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized). However, reasonable approximations of net capitalized expenditures may be used. For example, capitalized costs for an asset may be used as a reasonable approximation of capitalized expenditures unless the difference is material.

The Capitalization Period
17. The capitalization period shall begin when three conditions are present:

   a. Expenditures (as defined in paragraph 16) for the asset have been made.

   b. Activities that are necessary to get the asset ready for its intended use are in progress.

   c. Interest cost is being incurred.

Interest capitalization shall continue as long as those three conditions are present. The term activities is to be construed broadly. It encompasses more than physical construction; it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation. If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed. However, brief interruptions in activities, interruptions that are externally imposed, and delays that are inherent in the asset acquisition process shall not require cessation of interest capitalization.

18. The capitalization period shall end when the asset is substantially complete and ready for its intended use. Some assets are completed in parts, and each part is capable of being used independently while work is continuing on other parts. An example is a condominium. For such assets, interest capitalization shall stop on each part when it is substantially complete and ready for use. Some assets must be completed in their entirety before any part of the asset can be used. An example is a facility designed to manufacture products by sequential processes. For such assets, interest capitalization shall continue until the entire asset is substantially complete and ready for use. Some assets cannot be used effectively until a separate facility has been completed. Examples are the oil wells drilled in Alaska before completion of the pipeline. For such assets, interest capitalization shall continue until the separate facility is substantially complete and ready for use.

19. Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

Disposition of the Amount Capitalized

20. Because interest cost is an integral part of the total cost of acquiring a qualifying asset, its disposition shall be the same as that of other components of asset cost.

Disclosures

21. The following information with respect to interest cost shall be disclosed in the financial statements or related notes:

   a. For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period

   b. For an accounting period in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.

Effective Date and Transition

22. This Statement shall be applied prospectively in fiscal years beginning after December 15, 1979. Earlier application is permitted, but not required, in financial statements for fiscal years beginning before December 16, 1979 that have not been previously issued. With
respect to qualifying assets in existence at the beginning of the fiscal year in which this Statement is first applied for which interest cost has not been previously capitalized, interest capitalization shall begin at that time. With respect to qualifying assets for which interest cost has been capitalized according to a method that differs from the provisions of this Statement, no adjustment shall be made to the amounts of interest cost previously capitalized, but interest cost capitalized after this Statement is first applied shall be determined according to the provisions of this Statement. With respect to assets in existence when this Statement is first applied for which interest cost has been capitalized but which do not qualify for interest capitalization according to the provisions of this Statement, no adjustments shall be made, but no additional amounts of interest cost shall be capitalized.

23. If early application is adopted in financial reports for interim periods of a fiscal year beginning before December 16, 1979, previously issued financial information for any interim periods of that fiscal year that precede the period of adoption shall be restated to give effect to the provisions of this Statement, and any subsequent presentation of that information shall be on the restated basis. This Statement shall not be applied retroactively for previously issued annual financial statements.

15. FAS 42 provides the following guidance:

INTRODUCTION

1. Paragraph 8 of FASB Statement No. 34, Capitalization of Interest Cost, states that:

In concept, interest cost is capitalizable for all assets that require a period of time to get them ready for their intended use (an “acquisition period”). However, in many cases, the benefit in terms of information about enterprise resources and earnings may not justify the additional accounting and administrative cost involved in providing the information. The benefit may be less than the cost because the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. In that circumstance, interest capitalization is not required by this Statement.

Paragraph 9 of FAS 34 begins as follows:

Subject to the provisions of paragraph 8, interest shall be capitalized for the following types of assets (“qualifying assets”). . . .

2. The Board has received a number of questions concerning how paragraph 8 should be construed in deciding whether capitalization of interest is required. Some have stated that paragraph 8 appears to establish new tests of materiality that allow an enterprise to measure the effect of interest capitalization on income by a pro forma prospective or retroactive computation without also considering the effect on current year income. The Board has concluded that new tests of materiality should not be established for interest capitalization and has, accordingly, decided to amend paragraph 8 of Statement 34 to delete the language that gave rise to those questions.

3. The Board has concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 5 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to FASB Statement No. 34

4. The last two sentences of paragraph 8 of Statement 34 are superseded and replaced by the following sentence:

Accordingly, interest shall not be capitalized in the situations described in paragraph 10.
The introduction of paragraph 9 of Statement 34 is amended to read as follows:

Interest shall be capitalized for the following types of assets ("qualifying assets"):

Effective Date and Transition

5. This Statement shall be effective for fiscal years beginning after December 15, 1979. The provisions of this Statement shall be applied at the same time as the provisions of Statement 34 are first applied. Enterprises that already have adopted the provisions of Statement 34 shall apply the provisions of this Statement in their next fiscal year beginning after October 15, 1980 and may, but are not required to, restate their financial statements for the year of initial adoption to reflect the provisions of this Statement.

16. FAS 58 provides the following guidance:

INTRODUCTION

1. The FASB has received several inquiries concerning (a) the limitations of FASB Statement No. 34, Capitalization of Interest Cost, relating to capitalization of interest cost in situations involving investees accounted for by the equity method and (b) the inconsistent requirements between (i) the limitations of Statement 34 on the capitalization of interest cost in situations involving investees accounted for by the equity method and (ii) the requirement of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, that income and owners’ equity amounts should be the same whether a subsidiary is consolidated or accounted for by the equity method.

2. The basic issue is whether Statement 34 distinguishes qualifying assets owned by the parent and consolidated subsidiaries from those owned by unconsolidated subsidiaries, joint ventures, and other investees accounted for by the equity method for purposes of determining the amount of interest cost to be capitalized in the investor's financial statements. Although paragraph 15 of Statement 34 clearly limits the amount of interest available for capitalization in consolidated financial statements to that shown in those statements, neither paragraph 9 nor paragraph 15 of Statement 34 is explicit regarding any similar limitations on qualifying assets.

3. The Board has concluded that qualifying assets as described in Statement 34 are limited to those of the parent company and consolidated subsidiaries. The Board has also concluded that certain investments (equity, loans, and advances) accounted for by the equity method are qualifying assets of the investor (including parent company and consolidated subsidiaries). For the investment to be a qualifying asset, the investee must be undergoing activities in preparation for its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investment ceases to be a qualifying asset when those operations begin. Subsequent accounting for interest capitalized on the investment is specified by paragraph 19(b) of Opinion 18.

4. This Statement does not affect the accounting for and reporting of capitalized interest cost in the separate financial statements of investees.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 34

5. The following subparagraph is added to paragraph 9 of Statement 34, which specifies the qualifying assets for which interest is to be capitalized:

   c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations.
6. The following subparagraphs are added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:

   c. Assets that are not included in the consolidated balance sheet of the parent company and consolidated subsidiaries

   d. Investments accounted for by the equity method after the planned principal operations of the investee begin

   e. Investments in regulated investees that are capitalizing both the cost of debt and equity capital

7. The following sentence is added to paragraph 20 of Statement 34, which specifies the accounting for interest after it is capitalized:

   Interest capitalized on an investment accounted for by the equity method shall be accounted for in accordance with paragraph 19(b) of Opinion 18 which states: “A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary.”

Amendments to Other Pronouncements

8. Paragraph 10 of ARB No. 51, Consolidated Financial Statements, requires accounting for a subsidiary on a step-by-step basis if control is obtained through purchase of two or more blocks of stock. Paragraph 19(m) of Opinion 18 requires retroactive adjustment for an investee that was previously accounted for on other than the equity method when that investee becomes qualified for use of the equity method. Paragraph 34 of APB Opinion No. 20, Accounting Changes, requires restatement of prior financial statements for changes in reporting entities. The following footnote is added to each of those paragraphs:

   The amount of interest cost capitalized through application of FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method, shall not be changed when restating financial statements of prior periods.

Effective Date and Transition

9. This Statement shall be effective for investments made after June 30, 1982 except that investments contracted for but not yet made may be accounted for as specified in the next sentence. Investments existing at the effective date or date of earlier adoption of this Statement (a) may be accounted for according to the provisions of this Statement or (b) may continue to be accounted for by the method of interest capitalization previously used even though not in accordance with the provisions of this Statement. Earlier application is encouraged. This Statement may be applied retroactively for annual financial statements that have not been issued but shall not be applied retroactively for previously issued annual financial statements.

17. FAS 62 provides the following guidance:

INTRODUCTION

1. The FASB has received a number of requests to reconsider the issue of offsetting interest income against interest cost in the application of FASB Statement No. 34, Capitalization of Interest Cost, for purposes of determining either capitalization rates or limitations on the amount of interest to be capitalized. FASB Technical Bulletin No. 81-5, Offsetting Interest Cost to Be Capitalized with Interest Income, states that Statement 34 does not permit such offsetting. Other requests have been received to consider the issue of capitalization of interest cost in situations in which qualifying assets are acquired using gifts and grants restricted to the purchase of the specified assets.
2. The Board has concluded that Statement 34 should be amended to require offsetting of interest income against interest cost in certain circumstances involving tax-exempt borrowings that are externally restricted as specified in paragraph 3. Those situations include many governmental borrowings and most governmentally sponsored borrowings (such as industrial revenue bonds and pollution control bonds). In such situations, interest earned generally is considered in and is significant to the initial decision to acquire the asset, and the capitalization of net interest cost provides a better measure of the entity’s net investment in the qualifying assets. The Board believes that in those circumstances the association is direct and the funds flows from borrowing, temporary investment, and construction expenditures are so intertwined and restricted as to require accounting for the total net cost of financing as a cost of the qualifying assets. The Board also concluded that in all other situations offsetting of interest income against interest cost is not appropriate. The Board further concluded that qualifying assets acquired with externally restricted gifts or grants should not be subject to capitalization of interest cost under Statement 34.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

3. Interest earned shall not be offset against interest cost in determining either capitalization rates or limitations on the amount of interest cost to be capitalized except in situations involving acquisition of qualifying assets financed with the proceeds of tax-exempt borrowings if those funds are externally restricted to finance acquisition of specified qualifying assets or to service the related debt.

4. The amount of interest cost capitalized on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted as specified in paragraph 3 shall be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings \(^1\) from the date of the borrowing until the assets are ready for their intended use. Interest cost of a tax-exempt borrowing shall be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization.

\(^1\) The interest cost and interest earned on any portion of the proceeds of the tax-exempt borrowings that are not designated for the acquisition of specified qualifying assets and servicing the related debt are excluded. The entire interest cost on that portion of the proceeds that is available for other uses (such as refunding of an existing debt issue other than a construction loan related to those assets) is eligible for capitalization on other qualifying assets.

Amendments to FASB Statement No. 34

5. The following subparagraph is added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:

\(f.\) Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose.

6. The following footnote is added at the end of the first sentence of paragraph 13 of Statement 34, which deals with determining the amount of interest cost to be capitalized:

*If qualifying assets are financed with the proceeds of tax-exempt borrowings and those funds are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized shall be determined in accordance with FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants.
7. The following footnote is added to paragraph 17 of Statement 34, which specifies the period for interest capitalization:

*In situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in Statement 62, the capitalization period begins at the date of the borrowing.

Rescission of Technical Bulletin
8. FASB Technical Bulletin No. 81-5, Offsetting Interest Cost to Be Capitalized with Interest Income, is rescinded upon issuance of this Statement.

Effective Date and Transition
9. This Statement shall be effective for tax-exempt borrowing arrangements entered into and gifts or grants received after August 31, 1982, with earlier application encouraged in financial statements that have not been previously issued. This Statement may be, but is not required to be, applied retroactively to previously issued financial statements for fiscal years beginning after December 15, 1979. If previously issued financial statements are restated, the financial statements shall, in the year that this Statement is first applied, disclose the nature of any restatement and its effects on income before extraordinary items, net income, and related per share amounts for each restated year presented.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

Generally Accepted Accounting Principles
- FASB Statement No. 34, Capitalization of Interest Cost
- FASB Statement No. 42, Determining Materiality for Capitalization of Interest Cost
- FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method
- FASB Statement No. 62, Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants

State Regulations
- No additional guidance obtained from state statutes and regulations.
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Statutory Issue Paper No. 45

Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain guidance on accounting for bonds sold subject to reverse repurchase agreements and dollar repurchase agreements.

2. The purpose of this issue paper is to establish statutory accounting principles for repurchase and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

Repurchase Agreements

4. Repurchase agreements shall be defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

5. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income calculated on a straight-line basis or scientific interest (constant yield) basis over the term of the agreement.

6. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall be used to reduce the admitted asset value of the repurchase agreement.
Reverse Repurchase Agreements
7. Reverse repurchase agreements shall be defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria set forth in paragraph 23 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

8. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense on a straight-line basis or computed using the scientific (constant yield) interest method over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of these transactions and their associated leverage impact to the financial statements.

Dollar Repurchase Agreements
9. Dollar repurchase and dollar reverse repurchase agreements shall be defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria set forth in paragraph 23, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.
Separate Transactions
14. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 4, 7, or 9 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting
15. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:
   a. A legal right of offset exists as defined in Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76), or
   b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System (Fedwire system).

Otherwise, separate assets and liabilities shall be recognized.

Disclosures
16. The following disclosures shall be made in the notes to the financial statements.
   a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security.
   b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (a) securities subject to reverse repurchase agreements, (b) securities subject to repurchase agreements, (c) securities subject to dollar repurchase agreements, and (d) securities subject to reverse dollar repurchase agreements.
   c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

DISCUSSION
17. The conclusion above adopts current statutory guidance for repurchase agreements, reverse repurchase agreements, and dollar repurchase and reverse repurchase agreements, with a modification to the definition of substantially the same security in the case of mortgage backed securities to be consistent with the “good delivery” standard in AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position (SOP 90-3). The disclosure requirements are consistent with information requested in the general interrogatories section of the annual statement and have been expanded to include disclosure of the reporting entity’s policy for requiring collateral or other security.

18. The conclusion above is consistent with GAAP, and, accordingly, adopts SOP 90-3 and FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. Furthermore, the conclusion in this issue paper is consistent with the FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to
Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB No. 10 and a modification of FASB Interpretation No. 39. FIN 39 and FIN 41 are adopted in Issue Paper 76.

19. This issue paper also adopts paragraphs 9 through 13, 15 through 17, 23 through 25, 27 through 30 and 66 through 71 of FAS 125 as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements. Paragraph 14 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts in that repurchase agreements are reduced by the amounts of any collateral shortfalls. The guidance also prohibits the recognition of gains on sales of securities when there is an agreement to repurchase.

Drafting Notes/Comments
- AVR/IMR is addressed in Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

21. Chapter 1 in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies contain the following guidance relating to repurchase agreements and dollar repurchase agreements:

When a bond is sold and an equivalent security (a security of the same issuer having equal principal value, coupon rate, and maturity date) is to be repurchased pursuant to the terms of the reverse repurchase agreement, the transaction is accounted for as a financing (borrowing) transaction. A liability is recorded for the amount of the proceeds of the sale and the sold securities are not removed from the accounting records. The differential in the selling price and the repurchased price is recorded as interest expense and not netted against interest income. Amortization of original premium or accrual of original discount and interest income on the sold securities are recorded as though the securities had not been sold.

When a bond is sold and a security which is not an equivalent security is to be repurchased pursuant to a reverse repurchase agreement, the transaction is to be accounted for as two separate transactions. The sold security, including unamortized original premium for or unaccrued original discount, is to be removed from the accounting records and the resulting gain or loss recognized immediately. When the non-equivalent security is acquired pursuant to the reverse repurchase agreement, it is recorded at cost.

Dollar Repurchase Agreements

A dollar repurchase agreement is an agreement (contract) to sell and repurchase pass-through certificates sponsored by the Government National Mortgage Association (GNMA), mortgage participation certificates issued by the Federal Home Loan Mortgage Corporation (FHLMC) or similar securities issued by the Federal National Mortgage Association (FNMA). These instruments are generally referred to as mortgage-backed securities. These contracts do not fall under the definition of equivalent securities previously discussed under Loaned Bonds or Bonds Subject to Reverse Repurchase Agreements.
Where the law, rules, or regulations of the insurer's state of domicile permit such activity, mortgage-backed securities sold and reacquired under a dollar repurchase agreement or purchased and resold under a reverse dollar repurchase agreement should be accounted for as discussed below.

In dollar repurchase/dollar reverse repurchase agreements, the mortgage-backed securities involved may or may not be substantially the same. If the mortgage-backed securities are substantially the same, the dollar repurchase or dollar reverse repurchase agreement is treated as a financing. If the mortgage-backed securities are not substantially the same, the transactions are treated as a sale and purchase or purchase and sale of different securities.

For mortgage-backed securities to be substantially the same, all the following criteria must be met:

1. The mortgage-backed securities must have the same primary obligor, except for securities guaranteed by the United States or an agency thereof, in which case the guarantor must be the same.
2. The mortgage-backed securities must be identical in form and type. For example, the exchange of GNMA I securities for GNMA II securities would not meet the criterion.
3. The mortgage-backed securities must bear the identical contractual interest rate.
4. The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
5. The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
6. The aggregate principal amounts of the mortgage-backed securities sold and repurchased must be substantially the same. For mortgage-backed securities to meet this criterion, the principal amount of the certificates repurchased must be within 2.5% (plus or minus) of the principal amount of the original certificates. For example, if the principal amount of mortgage-backed securities sold is $1,000,000, the principal amount of mortgage-backed securities reacquired must be between $1,025,000 and $975,000 to qualify under this criterion.

If the mortgage-backed securities involved in a dollar repurchase agreement qualify under the above criteria, the transactions shall be treated as financing for statutory accounting purposes. A liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities.

When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased may be more or less than the book value of the mortgage-backed securities sold (within 2.5%).

If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded. For example, assume that the certificates sold had a book value of $1,000,000 and a market value of $800,000 on the date of sale. This represents a fair market value 20% below the book value. On the date of repurchase, the new certificates have a principal amount of $990,000 (within 2.5% of the book value at date of sale). A loss of $2,000 ($1,000,000—$990,000 x 20%) is recorded.
22. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies include the following in the general interrogatories related to repurchase and reverse repurchase agreements.

20. The information to be reported on all such transactions including securities involved in reverse repurchase agreements, loaned to others, and for any other securities that were made available for use by another person during the year covered by this statement must include, but not necessarily be limited to, the following items for each such transaction:

(1) Dates of transaction—securities delivered on ____________________
    securities returned on ____________________

(2) Complete description of securities involved ______________

(3) Number of shares or amount of bond or other security ______________

(4) Market value on date securities were delivered $ ______________

(5) Market value on date securities were returned $ ______________

(6) Collateral value held $ __________________________________

(7) Form of collateral _______________________________________

(8) Collateral held by _______________________________________
    (name and address)

(9) Names and addresses of all other persons involved in transaction ______________________________________________

Assets owned at year-end which were not under the exclusive control of the company as shown in the General Interrogatories are to be identified in the asset schedules by placing the following symbols to the far right in the description column alongside each such asset:

LS - loaned or leased to others;
RR - subject to reverse repurchase agreement;
DR - dollar repurchase agreement;
DRR - dollar reverse repurchase agreement;
C - pledged as collateral;
DB - placed under option agreement;
DBP - placed under an option agreement involving "asset transfers with put options";
R* - letter stock or otherwise restricted as to sale;
O - other.

Companies that had reverse repurchase agreements for periods of two working days or less, with numerous transactions, should combine those transactions in a separate report or each federally insured financial institution and respond to items (4), (5), and (8) as shown in this interrogatory.

Companies should complete a full report for all other transactions, for everything owned at December 31 and respond to all nine items in this interrogatory.

* Private placements are not to be included unless specific restrictions as to sale are included as part of the security agreement.
Generally Accepted Accounting Principles

23. AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position* (SOP 90-3) provides the following guidance:

.13 To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of substantially the same should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.1

1 The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered substantially the same.

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.2

2 For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary “in form and type”); commercial paper for redeemable preferred stock.

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.3

3 For example, the exchange of a “fast-pay” GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a “slow-pay” GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.4
Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, which is published by PSA.

24. **FASB Interpretation No. 39 Offsetting of Amounts Related to Certain Contracts -- an interpretation of APB Opinion No. 10 and FASB Statement No. 105** provides the following guidance:

5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

2. For purposes of this Interpretation, cash on deposit at a financial institution is to be considered by the depositor as cash rather than as an amount owed to the depositor.

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

3. This Interpretation does not address derecognition or nonrecognition of assets and liabilities. Derecognition by sale of an asset or extinguishment of a liability results in removal of a recognized asset or liability and generally results in the recognition of gain or loss. Although conceptually different, offsetting that results in a net amount of zero and derecognition with no gain or loss are indistinguishable in their effects on the statement of financial position. Likewise, not recognizing assets and liabilities of the same amount in financial statements achieves similar reported results.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

25. **FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements -- an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41)** states the following:

**INTRODUCTION**

1. The Board has been asked to clarify the circumstances in which amounts recognized as payables under repurchase agreements may be offset against amounts recognized as
receivables under reverse repurchase agreements\(^2\) and reported as a net amount in the statement of financial position.

\(^1\) For purposes of this Interpretation, a repurchase agreement (repo) refers to a transaction that is accounted for as a collateralized borrowing in which a seller-borrower of securities sells those securities to a buyer-lender with an agreement to repurchase them at a stated price plus interest at a specified date or in specified circumstances. The “payable” under a repurchase agreement refers to the amount of the seller-borrower's obligation recognized for the future repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “reverse repo.”

\(^2\) For purposes of this Interpretation, a reverse repurchase agreement (reverse repo) refers to a transaction that is accounted for as a collateralized lending in which a buyer-lender buys securities with an agreement to resell them to the seller-borrower at a stated price plus interest at a specified date or in specified circumstances. The “receivable” under a reverse repurchase agreement refers to the amount due from the seller-borrower for the repurchase of the securities from the buyer-lender. In certain industries, the terminology is reversed; that is, entities in those industries refer to this type of agreement as a “repo.”

INTERPRETATION

2. Paragraph 5 of FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts, sets forth the conditions necessary for a right of setoff to exist. Those conditions should be present to offset assets and liabilities in the statement of financial position unless offsetting is permitted by paragraph 10 of Interpretation 39 or by another accounting pronouncement listed in paragraph 7 of Interpretation 39.

3. Notwithstanding the condition in paragraph 5(c) of Interpretation 39, an enterprise may, but is not required to, offset amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements if all of the following conditions are met:

   a. The repurchase and reverse repurchase agreements are executed with the same counterparty.

   b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.

   c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.\(^3\)

   d. The securities underlying the repurchase and reverse repurchase agreements exist in “book entry” form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.\(^4\)

\(^3\) The qualifications for a master netting arrangement are stated in paragraph 10 of Interpretation 39 and are discussed in paragraphs 21 and 30 of that Interpretation.

\(^4\) “Book entry” securities meeting the criterion in paragraph 3(d) exist only as items in accounting records maintained by a transfer system operator. This requirement does not preclude offsetting of securities held in “book entry” form solely because other securities of the same issue exist in other forms.
The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraph 4, and the enterprise must have associated banking arrangements in place as described in paragraph 4. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable\(^5\) that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit\(^6\) at the settlement date for each of the parties.

\(^5\) The term probable is used in this Interpretation consistent with its use in paragraph 3(a) of FASB Statement No. 5, Accounting for Contingencies, to mean that a transaction or event is likely to occur.

\(^6\) Daylight overdraft or other intraday credit refers to the accommodation in the banking arrangements that allows transactions to be completed even if there is insufficient cash on deposit during the day provided there is sufficient cash to cover the net cash requirement at the end of the day. That accommodation may be through a credit facility, including a credit facility for which a fee is charged, or from a deposit of collateral.

The enterprise intends to use the same account at the clearing bank or other financial institution at the settlement date in transacting both (1) the cash inflows resulting from the settlement of the reverse repurchase agreement and (2) the cash outflows in settlement of the offsetting repurchase agreement.

The enterprise's choice to offset or not must be applied consistently. Net receivables resulting from the application of this Interpretation should not be offset against net payables resulting from the application of this Interpretation in the statement of financial position.

4. In a securities transfer system for repurchase and reverse repurchase agreements that meets the requirements of paragraph(e), cash transfers are initiated by notification from the owner of record of the securities to its securities custodian\(^7\) to transfer those securities to the counterparty to the agreement. Under associated banking arrangements, each party to a same-day settlement of both a repurchase agreement and a reverse repurchase agreement would be obligated to pay a gross amount of cash for the securities transferred from its counterparty but would be able to reduce that gross obligation by notifying its securities custodian to transfer other securities to that counterparty the same day. Thus, each party is responsible for maintaining available cash on deposit only for the amount of any net payable unless it fails to instruct its securities custodian to transfer securities to its counterparty.\(^8\) If both parties transfer the appropriate securities in settlement of the repurchase and reverse repurchase agreements, the party with a net receivable will not need any cash to facilitate the settlement, while the party with a net payable will need only to have available the required net amount due at the end of the business day.

\(^7\) The securities custodian for a securities transfer system may be the bank or financial institution that executes securities transfers over the securities transfer system, and "book entry" securities exist only in electronic form on the records of the transfer system operator for each entity that has a security account with the transfer system operator. "Book entry" securities exist only as items of account on the "controlling" records of the transfer system operator. Banks or other financial institutions may maintain "subsidiary" records of "book entry" securities. "Book entry" securities may be transferred on the subsidiary records of a bank or financial institution but, for entities that have a security account with the transfer system operator, may be transferred from the account of such an entity only through the transfer system operator.

\(^8\) Failure by either party to instruct its securities custodian to transfer securities owned of record would result in that party's failing to receive cash from the counterparty and, thereby, would require that party to have available cash on deposit for the gross payable due for securities transferred to it.
The failure also should be an event of default under the master netting arrangement required by paragraph 3(c). The event of default, in turn, should entitle the other party to terminate the arrangement and demand the immediate net settlement of all contracts.

26. FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33).

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
d. Recognize in earnings any gain or loss on the sale. The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

3 Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).4

4 As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity’s intent to hold other debt securities to maturity in the future.

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party
has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor’s right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released\(^5\) from being the primary obligor under the liability, either judicially or by the creditor.

\(^5\) If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:

a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security

b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding

c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value

e. For all servicing assets and servicing liabilities:

(1) The amounts of servicing assets or liabilities recognized and amortized during the period

(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Agreements That Maintain Effective Control over Transferred Assets
27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights
c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
d. Identical contractual interest rates
e. Similar assets as collateral
f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

9In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Repurchase Agreements and “Wash Sales”

66. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor (“repo party”) transfers a security to a transferee (“repo counterparty” or “reverse party”) in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated “interest factor”.

12 Other securities or letters of credit rarely are exchanged in repurchase agreements instead of cash.
67. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does no have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements calls for repurchase of securities that need not be identical to the securities transferred.

68. If the criteria of paragraph 9 are met, including the third criterion, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Others transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

70. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowing. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as securities sold, qualify as borrowing if the return of substantially the same (paragraph 28) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

71. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the terms of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets. In those circumstances, the transferee does not acquire the right to sell or repledge the securities during the term of the repurchase agreement; therefore, it does not have access to the benefits embodied in those assets. The transferee shall not record those assets as its own, nor shall the transferor derecognize those assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 1, Bonds and Loaned Backed and Structured Securities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 1, Bonds and Loan Backed and Structured Securities
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies

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Generally Accepted Accounting Principles
- AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts -- an interpretation of APB Opinion No. 10 and FASB Statement No. 105
- FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements -- an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39
- FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 46

Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

STATUS
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Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in subsidiaries, controlled and affiliated entities (hereafter referred to as SCA entities) specifies various valuation bases. The basic guidance is set forth in the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures) and the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. GAAP guidance requires consolidation of majority-owned and controlled subsidiaries and the equity method for all other significant investments in subsidiaries and other entities where the reporting entity has the ability to exercise significant influence over operating and financial policies of the investee. Consolidation of majority-owned subsidiaries was rejected in Issue Paper No. 1 - Consolidation of Majority-owned Subsidiaries.

2. The purpose of this issue paper is to establish statutory accounting principles for investments in SCA entities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

3. A parent and subsidiary shall be defined as:

   a. Parent - An entity that directly or indirectly owns and controls the reporting entity.

   b. Subsidiary - An entity that is, directly or indirectly, owned and controlled by the reporting entity.

4. An affiliate shall be defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and partnerships, joint ventures and limited liability companies as defined in Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies (Issue Paper No. 48). Those entities are accounted for under the guidance provided in Issue Paper No. 48 which requires the equity method for all such investments.

5. Control means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the investee, whether through the ownership of voting securities, by contract other than a commercial contract for goods or nonmanagement services, by common management, or otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a
second member of the group has an 8% interest in the same entity the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

6. Investments in SCA entities meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this paper.

Applying the Market Valuation, Statutory Equity and GAAP Equity Methods

7. The admitted investments in SCA entities shall be recorded using a market valuation approach (as described in paragraph 7 a.), or equity methods (as described in paragraph 7 b.).

a. In order to use the market valuation approach for SCA entities, the following requirements apply:

i. Once the reporting entity elects to use the market valuation approach for a particular subsidiary, the reporting entity cannot change the valuation method to another method (e.g., equity) without the approval of the domiciliary commissioner;

ii. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

iii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for their calculation of the subsidiary’s market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;

iv. Ownership percentages for determining the discount rate shall be measured at the holding company level;

v. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vii. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public’s control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.
b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 7 a. or, if the requirements are met, but a reporting entity elects not to use that approach, investments in SCAs shall be recorded as follows:

i. Investments in insurance SCA entities shall be recorded based on the underlying statutory equity of the respective entity’s financial statements, adjusted for unamortized goodwill as provided for in Issue Paper No. 68 – Business Combinations and Goodwill (Issue Paper No. 68);

ii. Investments in noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the underlying equity of the respective entity’s financial statements adjusted to a statutory basis of accounting and the resultant proportionate share of the subsidiary’s adjusted surplus, adjusted for unamortized goodwill as provided for in Issue Paper No. 68. Examples include but are not limited to: 1) an insurer and a SCA entity that leases autos, furniture, office equipment, or computer equipment to the insurer, 2) an insurer and a SCA entity that owns real estate property that is leased to the insurer for office space, and 3) an insurer and an SCA entity which holds investments which an insurer could acquire directly (i.e., “look through” investment subsidiary);

iii. Investments in noninsurance SCA entities that have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, shall be recorded based on the audited GAAP equity of the investee. Examples include but are not limited to: 1) a property-casualty or life insurer and a SCA entity that is an oil and gas venture, and 2) a property-casualty or life insurer and a SCA manufacturer.

8. For investments in entities recorded on the underlying audited GAAP equity of the investee the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in Issue Paper No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity’s share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity’s share of adjustments that are recorded directly to the investee’s stockholder’s equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.

9. The statutory equity method of accounting, as described in subparagraph 7 b. i., shall be applied by recording an initial investment in an investee at cost, which is defined in Issue Paper No. 68 as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. After the date of acquisition, the initial investment amount shall be adjusted for the amortization of goodwill and to recognize the reporting entity’s share of statutory basis earnings or losses and other changes in surplus (including changes in nonadmitted assets) of the investee. This represents the carrying amount of the investment. To apply the equity method of accounting to investees as described in subparagraphs 7 b. ii., certain adjustments shall be made to GAAP (or other basis) income to determine the reporting entity’s share of the investee’s statutory earnings and losses and other changes in surplus. Further guidance on recording the initial investment (including goodwill and negative goodwill) and other aspects of applying the equity method are discussed in paragraph 11 below.
10. If the reporting entity is using an equity method, the reporting entity’s share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity’s share of other changes in the investee’s surplus (e.g., the change in the investee’s nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 7 a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

11. The procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting, as applicable, to investments in SCA entities:

   a. A difference between the cost of an investment and the underlying equity in the statutory book value (GAAP book value if a noninsurance SCA entity that has significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates) of the acquired company at the date of acquisition shall be accounted for in accordance with Issue Paper No. 68.

   b. A transaction of an investee of a capital nature that affects the reporting entity’s share of stockholders’ equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity’s equity ownership in the investee, the reporting entity’s recorded investment shall be adjusted to reflect the transaction).

   c. Realized gains or losses on the sale of an investment in an SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss.

   d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee’s current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period.

   e. A reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that the equity method was suspended.

   f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee’s preferred dividends, whether or not such dividends are declared.

   g. An investment in an SCA entity may fall below the level of ownership described in paragraph 5 from the sale of a portion of an investment by the reporting entity, the sale of additional
interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the reporting entity’s share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

h. An investment in a SCA entity that was previously accounted for under one method may become qualified for use of another method (as described in paragraph 7) because of a change in the level of ownership (i.e., acquisition of additional interests by the reporting entity, acquisition or retirement of interests by the investee, or other transactions, or a change in facts or circumstances (e.g., paragraphs 7 a. i., 7 a. viii.)). When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity’s equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

12. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a down-stream SCA entity, the directly held entity, which owns the parent’s shares, shall have its value reduced for the reciprocal ownership.

13. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

Impairment

14. When there is a decline in the fair value of an asset owned by an SCA entity that is deemed to be other than temporary, the SCA entity shall write the asset down to fair value.

15. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with Issue Paper No. 5. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures

16. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follow shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:
a. Financial statements of a reporting entity shall disclose (1) the name of each SCA entity and percentage of ownership of common stock, (2) the accounting policies of the reporting entity with respect to investments in SCA entities and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference.

b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed.

c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups.

d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor’s share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity.

17. Any commitment or contingent commitment to a subsidiary, controlled or affiliated entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

18. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment writedown:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment.

   b. The amount of the impairment and how fair value was determined.

DISCUSSION

19. The statutory accounting principles described in the summary conclusion section are consistent with current statutory accounting guidance for investments in SCA entities except as follows:

   a. Current statutory guidance provides reporting entities with five alternatives for the valuation of common stock investments in subsidiary, controlled and affiliated companies: (1) statutory capital and surplus value, (2) net worth excluding nonadmitted assets, (3) net worth based on audited GAAP financial statements, (4) cost adjusted to reflect statutory basis operating results and (5) market value. Selection of the appropriate alternative depends on whether the investee is an insurance company, whether its stock is publicly traded and whether it is a noninsurance company with audited financial statements.

   b. Current statutory accounting guidance allows investments in noninsurance companies to be carried on the audited GAAP equity basis of accounting regardless of the nature of the investee’s business operations and its relationship to the investor’s business operations. However, in certain circumstances adjustments to reflect the equity in net assets on a statutory basis are required.
c. Current statutory accounting guidance permits, in certain situations, the recognition of equity in an SCA entity’s earnings as income rather than unrealized gains and losses in the reporting entity’s financial statements.


a. APB 18 defines control as ownership of over 50% of the outstanding voting stock but states that it may exist with a lesser percentage of ownership. The statutory accounting principles above define control as ownership of 10% or more of the outstanding voting interests.

b. APB 18 specifies the GAAP equity method of accounting for investments where the investor has the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less and specifies investments of 20% or more should lead to a presumption that an investor has such influence unless there is evidence to the contrary. The statutory accounting principles above specify the statutory equity method, if applicable, for investments of 10% or more of the voting interests unless predominant evidence to the contrary is presented.

c. APB 18 paragraph 19 c. specifies that under the GAAP equity method, an investor recognizes its share of the earnings or losses of an investee in the income statement as a single amount except for extraordinary items, whereas the statutory accounting principles described in paragraph 10 of the conclusion above specify when amounts shall be included in unrealized gains and losses or investment income.

21. The statutory accounting principles described in paragraph 5 above state control shall be presumed to exist for investees for which 10 percent or more of the voting interest is owned and presumed not to exist for investees for which less than 10 percent of the voting interest is owned. These presumptions can be overcome if there is predominant evidence to the contrary. FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investment in Common Stock an Interpretation of APB Opinion No. 18* (FIN 35), provides guidance on determining when such evidence exists. This issue paper adopts FIN 35 which is included in its entirety in paragraph 29.

22. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

**Conservatism**

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

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

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

23. The statutory accounting principles outlined in the conclusion above require that the investment for noninsurance SCA entities that have no significant ongoing operations other than to hold assets that are primarily for the direct or indirect benefit or use of the reporting entity or its affiliates, and that do not qualify for the market valuation approach outlined in paragraph 7 a. or for which the reporting entity does not elect that approach, shall be recorded based on their underlying equity adjusted to a statutory basis of accounting. In applying the provisions of this issue paper to noninsurance SCA entities, the focus is on the primary operations of the SCA for purposes of determining if it is ancillary to the insurance industry and thereby requiring the application of provisions under subparagraph 7 b ii. Entities whose primary operations do not provide services to the insurance industry fall under provisions of subparagraph 7 b. iii. It is not the intent of subparagraph 7 b. ii. to apply to an affiliate which has insignificant transactions within the insurance industry. Although this is a subjective rule, a bright line test would not benefit insurers or regulators. This rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination. This is consistent with the objectives of statutory financial reporting which emphasize the measurement of solvency for the protection of policyholders. This is consistent with the concepts of conservatism and recognition described above.

Drafting Notes/Comments
- Business combinations and goodwill are addressed in Issue Paper No. 68 - Business Combinations and Goodwill.
- CMO special purpose subsidiaries are addressed in Issue Paper No. 86 - Securitization.
- Investment income due and accrued is addressed in Issue Paper No. 34 - Investment Income Due and Accrued.
- Accounting for related party transactions is addressed in Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
24. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides the following guidance:

CHAPTER 6

INVESTMENTS IN SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES

Recent times have evidenced an increasing interest on the part of insurers in acquiring or organizing subsidiary companies for expanded corporate activities. Some insurers have done this through the vehicle of a separate holding company, whereas others have accommodated this aspect of their corporate operations and expansion directly within the framework of an existing insurance company.
Increasing interest has also developed within the regulatory agencies of various states, as well as the National Association of Insurance Commissioners (NAIC), with respect to regulation of investments in subsidiaries and the valuation of such investments. State insurance regulators are also concerned about transactions and commitments among parent, subsidiary, controlled, and affiliated companies because of the potential for detrimental impacts upon a particular insurance company.

Within this chapter the term SCA is intended to include parent, subsidiary, controlled, and affiliated companies.

Investments in SCA companies include debt security loans to and preferred and common stock. In general, the accounting for each type of investment is the same as it would be for any other bond, preferred stock, or common stock investment except that there are some special valuation considerations.

Loans to SCA companies are accounted for in the same manner as any other private placement bond. Preferred stock and common stock investments in SCA companies are subject to valuation procedures described below under Valuation.

A subsidiary, controlled, or affiliated company is generally defined in terms of controlling ownership in a company's voting capital stock. Ownership of more than 50% provides undisputed control and 80% or more is sufficient for inclusion in a consolidated U.S. federal income tax return. When 50% or less of the outstanding stock is owned, control is dependent upon the influence that the owner of that block of stock may have on the other holders of outstanding capital stock.

The NAIC instructions for the annual statement define a "person" as an individual, corporation, or any other legal entity. A parent is any person that, directly or indirectly, owns or controls the insurer. A "subsidiary" is any person that is, directly or indirectly, owned or controlled by the insurer. An "affiliate" is any person that is, directly or indirectly, owned or controlled by the same person or by the same group of persons that, directly or indirectly, own or control the insurer. The term affiliate includes parents and subsidiaries. Control and affiliated status shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing 10% or more of the voting securities of any other person.

Allowable Investments

The insurance codes and regulations of the various states contain provisions setting forth the existing restrictions on investments in SCA companies by insurance companies and insurance holding companies. In general, a company may not invest, either directly or indirectly, an amount equal to or more than a certain percentage of its assets or its capital and surplus in the common stock of any one corporation. In the case of an investment in an insurance subsidiary, an insurance company may be allowed to invest amounts different from (generally in excess of) the amount allowable for investment in a non-insurance SCA company.

Valuation

The ultimate authority for SCA company valuation basis and procedures, as with other regulatory aspects of insurance operations, resides with the various state insurance departments. In practice, however, most states have come to utilize the provisions of the NAIC Purposes and Procedures of the Securities Valuation Office manual for the valuation of SCA companies. The specific provisions in this manual represent the efforts and recommendations of the NAIC Valuation of Securities (EX4) Task Force, and have been approved by the NAIC.

As noted in the NAIC Purposes and Procedures of the Securities Valuation Office manual, the principal alternatives for the valuation of common stock investments in SCA companies include:
1. Statutory capital and surplus value for an insurer whose common capital stock is not publicly traded.

2. Net worth of a non-insurance company, adjusted to use only those assets that would constitute admitted assets if owned directly by an insurance company.

3. Net worth of a non-insurance company provided the financial statements have been audited by an independent certified public accountant in accordance with generally accepted auditing standards. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Also, the value is subject to the limitations on goodwill and other intangible assets described below.

4. Cost adjusted to reflect subsequent operating results of the SCA company. Operating results for an insurer should be in accordance with statutory accounting requirements. Operating results of a non-insurance company should be from an independent certified public accountant's audited financial statement prepared in accordance with generally accepted accounting principles. Such value shall be adjusted to reflect the equity in net assets on a statutory basis for any down-stream insurance subsidiary. Any goodwill and other intangible assets are subject to the limitations described below.

5. Market value for a partially owned company that is listed and publicly traded on a national securities exchange or entered in the NASDAQ National Market System.

A valuation basis used shall be used consistently thereafter unless a change is substantiated as reasonable and approved in writing by the NAIC Securities Valuation Office staff.

An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by an insurer, via a down-stream subsidiary, controlled or affiliated company, the directly held company, which owns the parent’s shares, will have its value reduced for the reciprocal ownership.

Any parent insurer which owns an interest in itself via either direct or indirect ownership of a down-stream affiliate, which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the valuation of such affiliate. The Securities Valuation Office provides a worksheet for both of these reciprocal ownership elimination computations.

Valuation of common stock investments in SCA companies should be computed after provision for the liquidation value for any preferred stock interest in the SCA company.

The alternatives for market valuation of preferred stock investments in SCA companies are generally similar to those for non-SCA preferred shares. However, preferred stocks of wholly owned subsidiaries of insurance companies are valued in the same manner as the common stock of subsidiaries. The current manual should be consulted for the specific valuation basis in effect and the restrictions applicable to each basis.

Valuation of a CMO special purpose subsidiary is discussed in Chapter 1.

The change in value of subsidiaries is reported as part of the unrealized capital gain due to the change in the difference between asset value and cost.

Goodwill and Other Intangible Assets

The following provisions with respect to goodwill and other intangible assets are applicable:

1. Goodwill is defined as the difference between the cost and the net asset value of the subsidiary acquired. If the acquired subsidiary is an insurance company, statutory basis net asset value is used.
2. The statutory admissible amount of goodwill and other intangible assets in aggregate is limited at all times to a maximum of 10% of an insurance company's statutory capital and surplus.

3. For valuation purposes, the period over which goodwill may be written off (amortized to zero) is limited to 10 years.

4. Some special transitional provisions are included for goodwill in connection with subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

**Reporting on SCA Companies**

The NAIC Purposes and Procedures of the Securities Valuation Office manual provisions for the valuation of common stock investments in SCA Companies include requirements for the submission of reports on each SCA company to the Securities Valuation Office.

An original filing is to be made within 30 days after the acquisition or formation of a SCA company.

Thereafter, an annual filing is due not later than April 1 of each year for each directly and indirectly owned SCA company.

**Accounting for Subsidiaries**

Under statutory insurance accounting principles, the equity method of accounting for a subsidiary is usually limited to asset valuation of the subsidiary. The prevailing practice is to recognize equity in the undistributed income as an unidentified part of the unrealized capital gain due to change in the difference between asset value and cost. The practice of including equity in the undistributed income of subsidiaries in net gain from operations of a life insurer is followed by a minority of life insurers.

Accounting for a subsidiary using the equity method of accounting means that the parent company may recognize, in its income statement, its equity in the income of the subsidiary when it is reported by the subsidiary.

Under prevailing statutory accounting principles and practices, the accounting for a common stock investment in a subsidiary is the same as the accounting for any other common stock. The only difference is in the manner of investment valuation. However, the asset value of the subsidiary is the same under either of the acceptable alternatives described above. Nevertheless, the inclusion of equity in undistributed income of subsidiaries in net gain from operations can lead to certain abuses and, therefore, companies opting for its use should adhere to the following guidelines.

1. An insurer shall not include equity in undistributed income of subsidiaries in net gain from operations for any subsidiary unless it has the ability to exercise significant influence over the operating and financial policies of the subsidiary. That ability is presumed to exist for subsidiaries for which 20 percent or more of voting control is owned and is presumed not to exist for subsidiaries for which less than 20 percent of voting control is owned (unless otherwise defined by the domiciliary state). Both presumptions may be overcome by predominant evidence to the contrary. The ability to exercise influence or control may be indicated in several ways, such as representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.

2. If an insurer includes in net gain from operations the equity in undistributed income of subsidiaries from any subsidiary, the insurer shall apply that practice to all subsidiaries that meet or exceed the significant influence test of the preceding paragraph.
3. Prior to changing the method for any subsidiary, the insurer shall first obtain approval from its domiciliary regulatory authority.

4. The filing of such separate supplemental information as may be required to disclose the equity in the undistributed income of the subsidiary.

25. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies provides similar guidance as above with the exception that it does not allow a reporting entity the option of including the equity in undistributed net income of subsidiaries in operations.

26. The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners provides the following guidance in Section 5, Procedures for Valuing Common Stocks and Stock Warrants:

(B) Common Stocks of Subsidiary, Controlled or Affiliated Companies.

(a) Subject to the requirements of Section 5(B)(b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal share holdings as required by Section 5(B)(b)(x).

(i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or

(ii) subject to the limitations imposed herein and under Section 5(B)(b)(ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or

(If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5(B)(a)(v)); or

(iii) book value, defined as in Section 5(A)(c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or

(iv) subject to the limitations imposed under Section 5(B)(b)(ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public accountant audited financial statement prepared in accordance with generally accepted accounting principles; or
If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment “to reflect subsequent operating results” shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

(v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or

(vi) See Section 3(C)(2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.

(vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or

(viii) Any other value which the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.

(b) (i) The provisions of Section 5(B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.

(ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.

(iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.

(iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.

(v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5(B)(a)(ii) and its books are not audited at the time the valuation is included in the insurer’s annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.

(vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5(B)(a)(v), there shall be deducted from the otherwise determined value a sum equal to the value claimed...
for any of its assets which would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

(1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer's business; or

(2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.

(vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may request such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.

(viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:

(1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);

(2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,

(3) whether revaluation of assets is involved, and the reasonableness thereof.

(ix) With respect to values determined under Sections 5(B)(a)(ii) and 5(B)(a)(iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)

(a) For the purposes of this section, "goodwill" shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries "net asset value" shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.

(b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.
(c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.

(d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.

(e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.

(f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer’s capital and surplus shall be written off immediately by a direct charge to surplus.

(x) An insurer which owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent must reduce the value of such shares for the reciprocal ownership. When such shares are owned directly their value, as determined under any option of Section 5(B)(a), will be reduced by a percentage amount calculated by dividing the common stockholders equity of the owning insurer by the common stockholders equity of the parent whose shares are owned. A filing with the Securities Valuation Office under the provisions of Section 5(B)(b)(ii) is required. If the shares of the parent are owned indirectly by an insurer, via a downstream subsidiary, controlled, or affiliated (SCA) company, the value of the directly held SCA company which statutorily consolidates the SCA company, which owns the parent shares, into its annual statement will have its value reduced by an amount equal to the common stockholders equity of the SCA owner divided by the common stockholders equity of the parent company whose shares are owned, multiplied times the statement value of the parents shares on the books of the SCA company owning such shares.

Any parent insurer, which owns an interest in itself, i.e., treasury stock, via either direct or indirect ownership of a downstream insurance or non-insurance subsidiary controlled or affiliated (SCA) company which in turn owns shares of the parent insurer, shall eliminate its proportionate interest in these shares from the statutory value of such SCA company as determined under the provision of Section 5(B)(a) if owned directly or from the statutory value of the direct SCA company which consolidates on either a GAAP or Statutory accounting basis the results of the SCA company owning the parent insurer’s shares.

(xi) The SVO staff may question the reasonableness and appropriateness of the valuation basis or the resultant value for any subsidiary, controlled or affiliated company, and if, after giving notice and opportunity to be heard, the staff determines that such basis or value is not, under the specific circumstances of the case, reasonable and appropriate, the staff shall report such determination to the insurer and to the insurance department of the state in which the insurer is domiciled and may recommend to such department either an adjustment in valuation or the use of one of the other specified bases of valuation. The SVO staff shall notify the insurance departments of all states of any such determinations or redetermination of value. The SVO staff shall also report such findings of value to the Task Force.

27. The NAIC Annual Statement Instructions (Annual Statement Instructions) provide the following guidance:

SCHEDULE D PART 6 - SECTION 1
VALUATION OF SHARES OF
SUBSIDIARY, CONTROLLED OR AFFILIATED COMPANIES

If an insurer has any common stock or preferred stock reported for any of the following required groups, categories, or subcategories it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

<table>
<thead>
<tr>
<th>Group or Category</th>
<th>Line Number</th>
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<td>Preferred Stock:</td>
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<tr>
<td>Parent</td>
<td>0999999</td>
</tr>
<tr>
<td>U.S. Property &amp; Casualty Insurer</td>
<td>1099999</td>
</tr>
<tr>
<td>U.S. Life Insurer</td>
<td>1199999</td>
</tr>
<tr>
<td>Alien Insurer</td>
<td>1299999</td>
</tr>
<tr>
<td>Non-Insurer Which Controls Insurer</td>
<td>1399999</td>
</tr>
<tr>
<td>Investment Subsidiary</td>
<td>1499999</td>
</tr>
<tr>
<td>Other Affiliates</td>
<td>1599999</td>
</tr>
<tr>
<td>Subtotal - Common Stock</td>
<td>1699999</td>
</tr>
<tr>
<td>Total - Preferred and Common Stock</td>
<td>1799999</td>
</tr>
</tbody>
</table>

*NOTE: Investment Subsidiary shall mean any subsidiary, other than a holding company, engaged or organized primarily in the ownership and management of investments for the insurer. An investment subsidiary shall not include any broker dealer or a money management fund managing funds other than those of the parent company. The following criteria is applicable:

1. 95% or more of the investment subsidiary’s assets would qualify as admitted assets;
2. The investment subsidiary’s total liabilities are 5% or less of total assets;
3. Combining the pro-rata ownership shares of the assets of all the investment subsidiaries with the owning insurer’s assets does not violate any state requirements concerning diversification of investments or limitations on investments in a single entity; and
4. The investment subsidiary’s statement value does not exceed the imputed value on a statutory accounting basis. If the statement value does exceed the imputed statutory value, the insurer may either non-admit the excess or categorize such subsidiary in the “All Other Affiliates” category.

Column 1 - Description

List the preferred and common stock for each subsidiary, controlled, or affiliated (SCA) company, as defined in the General Section of the Annual Statement Instructions.

Description of preferred and common stock payable in a foreign currency should include the purchase price in that foreign currency.

All CUSIP numbers must conform to those published by the Securities Valuation Office (SVO). CUSIP numbers for all purchased publicly issued securities are available from the broker’s confirmation or the certificate and will be identical to those used by the SVO. For private placement securities NAIC has created a special number called a PPN to be assigned by the Standard and Poor’s CUSP Bureau.
NAIC numbers for privately placed (unregistered) securities (PPNs) owned prior to December 31, 1988, were made available to all insurers by the SVO in a special publication in early 1989 and are published in the December 31, 1989, and all subsequent versions of the Valuations of Securities manual. Number assignments for privately issued securities purchased subsequent to December 31, 1988, will be made by a special NAIC facility at the Standard and Poor’s CUSP Bureau. Call the SVO (212 285-0010) for details. Such a number must be obtained and provided to the SVO before any privately issued security in can be listed in the Valuations of Securities manual.

Column 3 - NAIC Valuation Method

Include the NAIC valuation method as detailed in the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners.

Any NAIC Valuation Method which has not been approved by the filing of a SUB 1 form with the NAIC Securities Valuation Office and which is entered by the insurer under its own judgment shall have the letter “Z” appended to the method designation.

Column 4 - Do Insurer’s Admitted Assets Include Intangible Assets Connected with Holding of Such Company’s Stock?

State whether the admitted assets shown by the insurer in this statement include, through the carrying value of stock of the SCA Company valued under the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, include intangible assets arising out of the purchase of such stock by the insurer or the purchase by the SCA Company of the stock of a lower-tier company controlled by the SCA Company. For purposes of this question, intangible assets at purchase shall be defined as the excess of the purchase price over the tangible net worth (total assets less intangible assets and total liabilities) represented by such shares as recorded, immediately prior to the date of purchase, on the books of the company whose stock was purchased.

Column 5 - If Yes, Amount of Stock Intangible Assets

If the answer in Column 4 is “Yes”, give the amount of intangible assets involved. The intangible assets shown for the SCA Company should include any intangible assets which are included in the SCA Company’s carrying value of the stock of one or more lower-tier companies controlled by the SCA Company. In all cases, the current intangible assets equal the intangible assets at purchase, as defined above, minus any write-off thereof between the date of purchase and the statement date. If the answer in Column 4 is “No”, state “N/A” in Column 5.

Columns 7 and 8 - Stock of Such Company Owned by Insurer on Statement Date

State the number of shares of stock of the SCA Company owned by the insurer on the statement date, and the percent owned of the outstanding shares of the same class.

SCHEDULE D - PART 6 - SECTION 2

If an insurer has any common or preferred stock reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number.

<table>
<thead>
<tr>
<th>Group or Category</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock</td>
<td>01999999</td>
</tr>
<tr>
<td>Common Stock</td>
<td>02999999</td>
</tr>
</tbody>
</table>
Column 1 - Name of Lower-Tier Company

List each company which is controlled by an SCA Company by means of a holding of a controlling block of the outstanding stock, either directly or through one or more intervening companies which are also so controlled. Do not include companies which are themselves SCA Companies listed in Section 1.

Column 2 - Name of Company Listed in Section 1 Which Controls Lower-Tier Company

If more than one SCA Company controls the lower-tier company, list each SCA Company and complete Columns 3 through 5 separately for each.

Column 3 - Amount of Intangible Assets Included in Amount Shown in Column 5, Section 1

As explained in the instructions for Section 1, this amount is based on the intangible assets at purchase of the stock of the lower-tier company, reduced by any subsequent write-off. The amount shown is also based on the proportionate ownership of the lower-tier company by the reporting insurer.

Columns 4 and 5 - Stock in Lower-Tier Company Owned Indirectly by Insurer on Statement Date

These figures represent the proportionate ownership by the reporting insurer through the particular SCA Company.

Generally Accepted Accounting Principles

28. APB 18 requires the equity method of accounting when the investors’ voting stock gives it the ability to exercise significant influence over operating and financial policies even though the investor holds 50% or less of the voting stock. Otherwise the cost method is required. APB 18 also requires disclosure of subsidiary information if significant in relation to investor’s financial position or results of operations. Rather than repeat APB 18 in the Relevant GAAP Literature Section of this paper a summary from The Current Text - Section I82 - Investments: Equity Method is provided.

INVESTMENTS: EQUITY METHOD SECTION I82

Sources: APB Opinion 18; AICPA Interpretations of APB Opinion 18; FASB Statement 58; FASB Statement 94; FASB Statement 109; FASB Statement 115; FASB Interpretation 35; FASB Technical Bulletin 79-19

Summary

The equity method is a method of accounting for investments. An investor using the equity method initially records an investment at cost. Subsequently, the carrying amount of the investment is increased to reflect the investor’s share of income of the investee and is reduced to reflect the investor’s share of losses of the investee or dividends received form the investee. The investor’s share of the income or losses of the investee is included in the investor’s net income as the investee reports them. Adjustments similar to those made in preparing consolidated financial statements, such as elimination of intercompany gains and losses and amortization of the difference between cost and underlying equity in net assets, also are applicable to the equity method. Under the equity method, and investment in common stock is generally shown in the balance sheet of an investor as a single amount. Likewise, an investor’s share of earnings or losses from its investment is ordinarily shown in its income statement as a single amount.

This section requires that an investor use the equity method to account for investments in corporate joint ventures. This section also requires use of the equity method to account for other investments in common stock if the investor has the ability to exercise significant influence over
operating and financial policies of the investee enterprise. That ability is presumed to exist for investments of 20 percent or more and is presumed not to exist for investments of less than 20 percent; both presumptions may be overcome by predominant evidence to the contrary.

29. FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock an Interpretation of APB Opinion No. 18*, provides the following guidance:

**INTRODUCTION**

1. The Board has been asked to clarify the provisions of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, regarding application of that method to investments of 50 percent or less of the voting stock of an investee enterprise (other than a corporate joint venture).

**INTERPRETATION**

2. Opinion 18 requires that the equity method of accounting be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee. The presumptions in paragraph 17 of Opinion 18 are intended to provide a reasonable degree of uniformity in applying the equity method. The presumptions can be overcome by predominant evidence to the contrary.  

3. Evidence that an investor owning 20 percent or more of the voting stock of an investee may be unable to exercise significant influence over the investee’s operating and financial policies requires an evaluation of all the facts and circumstances relating to the investment. The presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies stands until overcome by predominant evidence to the contrary.  

4. Examples of indications that an investor may be unable to exercise significant influence over the operating and financial policies of an investee include:

   a. Opposition by the investee, such as litigation or complaints to governmental regulatory authorities, challenges the investor’s ability to exercise significant influence.

   b. The investor and investee sign an agreement under which the investor surrenders significant rights as a shareholder.  

   c. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

   d. The investor needs or wants more financial information to apply the equity method than is available to the investee’s other shareholders (for example, the investor wants quarterly financial information from an investee that publicly reports only annually), tries to obtain that information, and fails.  

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Subject to the limitations on the use of the equity method identified in footnote 4 of Opinion 18. That footnote states that conditions that represent limitations on consolidation shall be applied as limitations to the use of the equity method. 

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See paragraph 9 of this Interpretation for a discussion of such agreements.
3 The subject of inability to obtain financial information also is addressed in the American Institute of Certified Public Accountants’ Codification of Statements on Auditing Standards, AU Section 332, “Evidential Matter for Long-Term Investments,” paragraph 9.

e. The investor tries and fails to obtain representation on the investee’s board of directors.

This list is illustrative and is not all-inclusive. None of the individual circumstances is necessarily conclusive that the investor is unable to exercise significant influence over the investee’s operating and financial policies. However, if any of these or similar circumstances exists, an investor with ownership of 20 percent or more shall evaluate all facts and circumstances relating to the investment to reach a judgment about whether the presumption that the investor has the ability to exercise significant influence over the investee’s operating and financial policies is overcome. It may be necessary to evaluate the facts and circumstances for a period of time before reaching a judgment.

EFFECTIVE DATE AND TRANSITION

5. The provisions of this Interpretation shall be effective for fiscal years beginning after June 15, 1981, with earlier application encouraged. Changes in the method of accounting for investments required by this Interpretation shall be recorded in accordance with paragraphs 19 (1) and (m) of Opinion 18, which provide that:

a. If the investor discontinues application of the equity method, the earnings and losses of the investee that were previously accrued shall remain as part of the carrying amount of the investment. The carrying amount of the investment shall not be adjusted retroactively.

b. If the investor begins applying the equity method, the investment, results of operations (current and prior periods presented), and retained earnings of the investor shall be adjusted retroactively.

This Interpretation was adopted by the unanimous vote of the seven member’s of the Financial Accounting Standards Board following submission to the Financial Accounting Standards Advisory Council.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, Investments in Subsidiary, Controlled and Affiliated Companies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, Investments in Subsidiary, Controlled and Affiliated Companies
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 5, Procedures for Valuing Common Stocks and Stock Warrants
- Issue Paper No. 1 - Consolidation of Majority-owned Subsidiaries
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies
- Issue Paper No. 68 - Business Combinations and Goodwill
Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
- FASB Interpretation No. 35, *Criteria for Applying the Equity Method of Accounting for Investments in Common Stock an Interpretation of APB Opinion No. 18*
- FASB Technical Bulletin 79-19, *Investor’s Accounting for Unrealized Losses on Marketable Securities Owned by an Equity Method Investee*
- FASB Emerging Issues Task Force No. 87-21, *Change of Accounting Basis in Master Limited Partnership Transactions*
- FASB Emerging Issues Task Force No. 96-16, *Investor’s Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 47

Uninsured Plans

STATUS
Finalized June 23, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P & C Accounting Practices and Procedures Manuals) provide guidance on the recording and reporting of transactions related to uninsured plans. GAAP does not specifically address these types of transactions.

2. The purpose of this issue paper is to establish statutory accounting principles for Administrative Services Only (ASO), Administrative Services Contract (ASC) and Medicare or similarly structured cost based reimbursement contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of this issue paper, uninsured accident and health plans, including HMO administered plans, and uninsured property and casualty plans (collectively referred to as uninsured plans) are defined as plans for which a reporting entity as an administrator, performs administrative services such as claims processing for a third party that is at risk, and accordingly, the administrator has not issued an insurance policy, regardless of whether an identification card is issued. In the case of uninsured accident and health plans, the administrator may arrange for the provision of medical services through a contracted or employed provider network. The plan (whether insured by another reporting entity or self insured) bears all of the insurance risk, and there is no possibility of loss or liability to the administrator caused by claims incurred related to the plan. The administrator, however, may be subject to credit risk with regard to the risk bearing entity. An uninsured accident and health plan may be either an ASO plan or an ASC plan. Under an ASO plan, claims are paid from a bank account owned and funded directly by the uninsured plan sponsor; or, claims are paid from a bank account owned by the reporting entity, but only after the reporting entity has received funds from the uninsured plan sponsor that are adequate to fully cover the claim payments. Under an ASC plan, the reporting entity pays claims from its own bank accounts, and only subsequently receives reimbursement from the uninsured plan sponsor. No arrangement where the reporting entity receives a capitated payment for providing medical services to a third party shall qualify as an insured plan.

4. Uninsured accident and health plans also include Federal, state or other government department funded programs such as Medicare cost contracts where there is no underwriting risk to the reporting entity. Under Medicare cost contracts, service provided to recipients includes the direct delivery of health care for which the reporting entity is reimbursed based on costs incurred as provided for in regulations governing the administration of such contracts. Other such programs may include some Medicaid and Champus contracts for which administration or other non-underwriting services are provided.

5. Partially insured or combination plans exist, under which the reporting entity issues an insurance policy for some of the risks related to the claims (e.g. minimum premium and stop-loss plans), but acts as an administrator for some, or all, of the claims paid by the plan. Such plans shall be treated as two plans: an insured plan (the part for which the reporting entity has issued a policy) and an uninsured plan (the
part that meets the definition in paragraph 3 of this issue paper). The components related to uninsured plans shall be accounted for using the accounting principles established in this issue paper; the components related to insured plans shall be accounted for as insurance.

Revenue/Expense Recognition
6. The administrator's statement of operations shall exclude all income and expenses related to claims, losses, premiums, and other amounts received or paid on behalf of uninsured ASO or uninsured ASC plans. An administrator acting as a provider of services, that provides such services through a salaried network, where the cost allocation of the service provided to insured v.s. uninsured plans cannot be reasonably determined, shall report medical and hospital expenses on a gross basis by type of expense and report revenue from uninsured plans on a gross basis as fee for service income.

7. Commissions, expenses, and taxes paid by the administrator to administer such plans shall be reported on a gross basis by type of expense. Where the only functions provided are administrative, administrative fees and related reimbursements from the plan shall be deducted from general expenses. Where the reporting entity provides both administration and health care services directly, income from Medicare or similarly structured cost based reimbursement contracts is not recorded as premium but is recorded as revenue on the appropriate line. Health care services rendered as “medical and hospital” categorized by type and administrative expenses by type of expense shall be reported on an incurred basis. Income from cost based reimbursement contracts is recorded as revenue because the service provided is for the direct delivery of care to recipients. There are risks associated with these plans in that all costs incurred under the contract may not be reimbursable and revenues may be adjusted based on subsequent challenges of costs included in filed cost reports. In addition, revenue may also be adjusted based on the performance under the terms of the contract or other external factors.

Amounts Receivable
8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly cost based reimbursement contract shall only be recorded when services have been rendered.

9. An evaluation shall be made of the amounts receivable to determine any nonadmitted amounts. Next, an evaluation shall be made in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), to determine whether there is an impairment. This two step process is set forth below:

a. Uncollected uninsured plan receivables (excluding Medicare and similar government plans) over ninety days due shall be accounted for as a nonadmitted asset;

b. Remaining amounts determined to be uncollectible shall be written off. If in accordance with Issue Paper No. 5, it is probable the amount receivable is uncollectible, any uncollectible amount receivable shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible and is therefore not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed. This evaluation may consider irrevocable letters of credit to which the administrator is beneficiary, amounts on deposit with the administrator or other unrestricted funds available to the administrator.
10. The following shall provide additional guidance in determining the nonadmitted portion of amounts receivable from uninsured plans:

   a. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements shall not be used to decrease the nonadmitted asset otherwise calculated;
   
   b. The due date is governed by the contractual billing date of the uninsured plan;
   
   c. Medicare and similar government funded plans - Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

Liabilities

11. A liability shall be established for funds held by an administrator in its general assets for the benefit of an insured plan, or for funds which may be owed by the administrator in connection with the administration of an uninsured plan. A liability relating to one plan shall not be offset by an asset relating to a different plan. Administrators shall not record aggregate reserves, claim/loss reserves, or liabilities (except for Medicare or similarly structured cost based reimbursement contracts) for any other claim costs paid by the administrator on behalf of uninsured plans.

Disclosure

12. The statutory financial statements shall provide the following:

   a. Information with regard to the profitability to the administrator of all ASO plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASO administrator;
      
      For the total and each category separately provided: (i) net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses, (ii) total net other income or expense (including interest paid to or received from plans), (iii) total net gain or loss from operations and (iv) the claim and reimbursement volume;
   
   b. Information with regard to the profitability to the administrator of all ASC plans and the uninsured portions of partially insured plans for which the reporting entity serves as an ASC administrator;
      
      For the total and each category separately provided: (i) gross reimbursement for medical cost incurred, (ii) gross administrative fees accrued, (iii) other income or expense (including interest paid to or received from plans), (iv) gross expenses incurred (claims and administrative) and (v) total net gain or loss from operations.
   
   c. Information with regards to Medicare or similarly structured cost based reimbursement contracts shall include: (i) major components of revenue by payor, (ii) receivables from payors with account balances the greater of 10% of gross Health Care Receivables or $10,000, (iii) recorded allowances and reserves for adjustment of recorded revenues, (iv) adjustments to revenue resulting from audit of receivables related to revenues recorded in the prior period.
DISCUSSION

13. The conclusion above adopts existing statutory accounting guidance for uninsured accident and health plans and extends this guidance to other uninsured plans. The current statutory accounting disclosure requirements were expanded to include claim and reimbursement volume.

14. The Statement of Concepts states:

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

15. Based upon the above concept, ASO, ASC and Medicare or similarly structured cost based reimbursement contract, plan assets and liabilities should reflect only amounts that are available to meet both current and future policyholder obligations and obligations of the reporting entity, respectively.

16. Under the conservatism concept of statutory accounting, ASO and ASC plan receivables which are over ninety days due, shall be treated as nonadmitted assets and charged to surplus. In keeping with the concept of conservatism, subsequent collection of nonadmitted assets shall not be considered in the determination of period-end nonadmitted assets. These recoveries shall be accounted for in the period received.

Drafting Notes/Comments
- Accounting for claims of insured plans are addressed in Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses.
- Accounting for property and casualty high deductible and retrospective insurance contracts are addressed in Issue Paper No. 65 - Property and Casualty Contracts and Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts, respectively.
- Accounting for Medicare and Medicaid Risk Contracts are addressed in Issue Paper No. 54 - Individual and Group Accident and Health Contracts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
17. Chapter 8, Other Admitted Assets, of the Life/A&H Accounting Practices and Procedures Manual discusses uninsured accident and health plans as follows:

Some insurers may act as administrators of accident and health plans under which the plans bear all of the risk of claims. Such plans are commonly termed administrative services only plans and are described in this manual as uninsured plans. The definition of risk used here for the purpose of classifying funding arrangements as they relate to the insurer is the possibility of liability to the insurer due to claims under an accident and health plan.

In addition to plans under which there is no risk to the insurer, there are also partially insured or combination plans. Such plans may include, but are not limited to, plans described as minimum premium, cost-plus/stop-loss, or other similar names. For purposes of statutory financial statement reporting, combination plans or partially insured plans should be treated as, in effect, two plans: one insured and one uninsured. For accounting purposes, the components of a partially insured plan which are applicable to insured benefits should be classified as one would any insured plan. Those components which are related to uninsured and administrative services only should be treated as if they apply to an uninsured plan.
A receivable from a plan relating to uninsured business must be reported as an asset and may not include amounts relating to claims unpaid by the insurer. Balances due and unpaid in excess of three months, except for those relating to Medicare or similar government plans, must be deducted as not admitted. Correspondingly, a liability must be established for a plan for which an insurer holds funds in its general assets or to which funds may be owed by the insurer, including funds due to certificate holders. An asset relating to one plan may not be offset by a liability relating to a different plan.


19. Chapter 13, Aggregate Reserves for Accident and Health Policies, of the Life/A&H Accounting Practices and Procedures Manual discusses aggregate reserves for uninsured accident and health plans as follows:

   The insurer’s aggregate reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established.

20. Chapter 10, Losses, of the P & C Accounting Practices and Procedures Manual discusses reserves for uninsured accident and health plans as follows:

   The insurer’s loss reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate loss and loss adjustment expense reserves established.

21. Chapter 14, Accident and Health Claims, of the Life/A&H Accounting Practices and Procedures Manual discusses claim reserves for uninsured accident and health plans as follows:

   The insurer’s claim reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established. This is the same treatment described with regard to aggregate reserves in Chapter 13.

22. Chapter 17, Other Liabilities, of the Life/A&H Accounting Practices and Procedures Manual discusses establishing a liability for uninsured accident and health plans as follows:

   Liability for Amounts Held Under Uninsured Accident and Health Plans

   A liability must be established for a plan for which an insurer holds funds in its general assets or to which funds may be owed by the insurer, including funds due to certificate holders. A liability relating to one plan may not be offset by an asset relating to a different plan.

23. Chapter 18, Premium Income, of the Life/A&H Accounting Practices and Procedures Manual discusses premium recognition on uninsured accident and health plans as follows:

   Amounts related to uninsured plans or the uninsured portion of partially insured plans must not be reported in premiums. Conversely income relating to the insured portion of any plan must be reported as premiums.


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25. Chapter 20, Policy and Contract Benefits, of the Life/A&H Accounting Practices and Procedures Manual discusses paying claims for uninsured accident and health plans as follows:

Claims paid by the insurer under uninsured accident and health plans and the uninsured portion of partially insured accident and health plans should not be reported in the Summary of Operations. Claims payments under the insured portion of partially insured plans are reported as accident and health benefits.

26. Chapter 17, Loss and Loss Adjustment Expenses Incurred, of the P & C Accounting Practices and Procedures Manual discusses losses paid on uninsured accident and health plans as follows:

Losses paid by the insurer under uninsured accident and health plans should not be reported in the underwriting and investment exhibits. Loss payments under the insured portion of partially insured plans are reported as accident and health losses.

27. Chapter 22, General Expenses and Taxes, Licenses and Fees, of the Life/A&H Accounting Practices and Procedures Manual discusses expenses of uninsured accident and health plans as follows:

Uninsured accident and health plans have been discussed in prior chapters of this manual. Commissions, expenses, and taxes incurred by the insurer for such plans are to be reported on a gross basis by type of expense; however, administration fees and expense reimbursements relating to uninsured business are deducted in the general expense exhibit and general insurance expenses are to be reported in the Summary of Operations net of such fees and reimbursements.


29. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, the NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies and the NAIC Annual Statement Instructions for Health Maintenance Organizations include the following disclosure requirements:

Gain or Loss to the Insurer from Uninsured A&H Plans and the Uninsured Portion of Partially Insured Plans

Instruction:

Provide information with regard to the profitability to the insurer (HMO) of uninsured accident and health plans and the uninsured portions of partially insured plans for which the company serves as administrator. For the total and each category separately provided: (1) net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses, (2) total net other income or expense (including interest paid to or received from plans), and (3) total net gain or loss from operations.
Illustration:

The gain from operations from uninsured accident and health plans and the uninsured portion of partially uninsured plans was as follows during 19XX:

<table>
<thead>
<tr>
<th></th>
<th>Uninsured Plans</th>
<th>Partially Insured Plans</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Net reimbursement for administrative expenses over (under) actual expenses</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>ii. Other income or (expenses)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>iii. Net gain or (loss) from operations</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

**Generally Accepted Accounting Principles**

30. There is no GAAP guidance specifically addressing Administrative Services Only plans.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 8, 13, 14, 17, 18, 20 and 22
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 10, 13, 14, 17 and 19
- NAIC Annual Statement Instructions for Property and Casualty Companies
- NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Health Maintenance Organizations

**Generally Accepted Accounting Principles**
- None

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 48
Investments in Joint Ventures, Partnerships and Limited Liability Companies

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for investments in joint ventures and partnerships specifies the equity method of accounting and is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. Current statutory accounting guidance does not address accounting for investments in limited liability companies.

2. GAAP addresses accounting for investments in partnerships and joint ventures in Accounting Interpretation of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stocks* (AIN APB 18). Although the interpretation states that Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stocks*, (APB 18) does not apply to investments in partnerships and joint ventures it suggests that many provisions of APB 18 may be applicable. As a result current practice generally is to account for such investments under the equity method.

3. The purpose of this issue paper is to establish statutory accounting principles for investments in joint ventures, partnerships, and limited liability companies that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper addresses accounting for investments in any joint venture, partnership, or limited liability company whether or not it is considered to be controlled by or affiliated with the reporting entity.

5. Investments in joint ventures shall include investments in:
   - corporate joint ventures, and
   - unincorporated joint ventures (also referred to as undivided interests in ventures).

   A corporate joint venture shall be defined as a corporation owned and operated by a small group (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A corporate joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An unincorporated joint venture is similar in its purpose but is not incorporated.

6. Investments in partnerships shall include investments in:
   - general partnership interests, and
   - limited partnership interests.
A general partnership shall be defined as an association in which each partner has unlimited liability. Each partner assumes joint and several liability for all partnership debts. A limited partnership shall be defined as a partnership having two classes of partners: (a) general partners who manage the partnership, subject to the partnership agreement, and have personal liability for the general obligations of the partnership and (b) limited partners who are passive investors and have no personal liability beyond their investment.

7. A limited liability company shall be defined as a form of business organization which is a hybrid of a corporation and partnership whereby the owners have limited liability like a corporation and profits may pass through to the owners for tax purposes like a partnership if certain criteria are met. The owner’s personal liability is limited to his own acts and the owners can fully participate in the management of the business with no adverse impact on their limited liability.

8. Investments in the ventures which are defined in paragraphs 5 through 7 meet the definition of assets defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this paper. Investments in joint ventures, partnerships and limited liability companies shall be included in Other Invested Assets in the financial statements.

9. Investments in such ventures, except for limited partnerships with a minor ownership interest, shall be reported using an equity method as defined in paragraphs 7 through 13 of Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities (Issue Paper No. 46). Limited partnerships in which the entity has a minor ownership interest (i.e., less than 10%) shall be recorded based on the underlying audited GAAP equity of the investee. The amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in paragraph 7 of Issue Paper No. 68 - Business Combinations and Goodwill). The carrying amount of the investment shall be adjusted to recognize the reporting entity’s share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any distributions received. A reporting entity’s share of adjustments that are recorded directly to the investee’s stockholder’s equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded to unrealized capital gains and losses on investments. The reporting entity’s share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity’s share of other changes in the investee’s surplus (e.g., the change in the investee’s nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. Distributions received from an investee shall be recognized in investment income when declared to the extent they are not in excess of the undistributed accumulated earnings attributable to the investee. If distributions declared exceed the investor’s share of undistributed accumulated earnings after the date of the investment, this excess portion of the distribution shall be applied to reduce the carrying value of the investment.

Impairment

10. For any decline in the fair value of an investment in a joint venture, partnership or limited liability company which is determined to be other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. Even if the fair value of an investment is below the carrying amount it is not necessarily indicative of a loss in value that is other than temporary. Similarly the existence of investee operating losses may indicate a loss in value; however, it is not necessarily indicative of a loss in value that is other
than temporary. All factors shall be considered in determining whether a loss in value is other than temporary.

**Disclosures**

11. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. Disclosures as follow shall be made for all investments in joint ventures, partnerships, or limited liability companies that exceed 10% of the total admitted assets of the reporting entity:

   a. Financial statements of a reporting entity shall disclose (1) the name of each joint venture, partnership or limited liability company and percentage of ownership, (2) the accounting policies of the reporting entity with respect to investments in joint ventures, partnerships and limited liability companies and (3) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., nonadmitted goodwill or other nonadmitted assets) and the accounting treatment of the difference.

   b. For those joint ventures, partnerships and limited liability companies for which a quoted market price is available, the aggregate value of each joint venture, partnership or limited liability company investment based on the quoted market price shall be disclosed.

   c. Summarized information as to assets, liabilities, and results of operations shall be presented for joint ventures, partnerships and limited liability companies either individually or in groups.

12. Any commitment or contingent commitment to a joint venture, partnership or limited liability company shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

13. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment.

   b. The amount of the impairment and how fair value was determined.

**DISCUSSION**

14. The statutory accounting principles described in paragraphs 8 through 13 above are consistent with current statutory accounting except as follows:

   - Current statutory accounting guidance addresses accounting for investments in partnerships and joint ventures but does not address accounting for investments in limited liability companies.

   - Current statutory accounting guidance does not address accounting or disclosures for other than temporary impairments.

   - Current statutory accounting guidance allows the reporting entity’s equity in the net earnings of the investee to be recorded, in certain situations, as net investment income.

15. The statutory accounting principle described in paragraph 9 above is inconsistent with the GAAP promulgated in paragraph 17 of APB 18 which specifies “an investment of less than 20% of the voting
stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. APB 18 is addressed in its entirety and rejected in Issue Paper No. 46. The related interpretation of APB 18, AIN APB 18, is also rejected.

16. The statutory accounting principles referred to in paragraph 9 above with respect to limited partnerships with a minor interest are inconsistent with GAAP guidance described in paragraph 8 of AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures (SOP 78-9), which requires the use of the cost method for investments in limited partnerships where the limited partner’s interest is so minor that the limited partner may have virtually no influence over the operating and financial policies. The remaining guidance in SOP 78-9 promotes the accounting prescribed under APB 18 which has been rejected in the above paragraph, therefore this issue paper rejects SOP 78-9.

17. The statutory accounting principles described in the conclusion above apply to limited liability companies. Limited liability companies are a form of business organization, authorized by statute in certain states, characterized by limited liability, management by members or managers, and limitations on the transferability of ownership interest. Limited liability companies have the potential for taxability as partnerships for federal income tax purposes. Although limited liability companies provide members with limited personal liability (traditionally available only to corporations and certain hybrids), this new form of organization typically has more qualities of a partnership than of a corporation. As a result, the accounting for investments in such organizations shall follow the accounting for investments in partnerships. This is consistent with the underlying characteristics of these entities which indicate that they generally have more qualities of a partnership than of a corporation.

18. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Conservatism

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

Recognition

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

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

Drafting Notes/Comments

- Accounting for business combinations with a venture are addressed in Issue Paper No. 68 - Business Combinations and Goodwill.
- Accounting for investments in subsidiary, controlled or affiliated entities and definition of the equity method of accounting for statutory accounting principles are addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. The Accounting Practices and Procedures Manual for Life and Accident and Health and Property and Casualty Insurance Companies provides the following guidance:

Chapter 8 - Other Admitted Assets

Partnerships and Joint Ventures

One investment alternative for insurers is the partnership or joint venture with equity interest in real estate, securities, petroleum and other assets. Real estate partnerships or joint ventures are the most predominant and include investments in apartment complexes, office buildings, shopping centers, mass housing projects, condominiums, and land purchases and sales.

A typical venture will be between partners who offer capital or expertise, or both, to invest in the undertaking. In such a venture, the partners usually are an insurance company (which provides the equity) and a developer (who provides the technical skill and performs the actual work).

The investment made by the insurance company can be the equity investment in the property being developed and/or the permanent financing of the venture (a mortgage loan). The equity investment is returned to the company through its share of cash contributions.

Each venture must maintain its own accounting records that report venture assets, liabilities, partnership equities, and operating income in conformity with generally accepted accounting principles. These are accounting records of the venture and not of the insurance company.

The accounting of a partnership or joint venture is similar to statutory accounting for a subsidiary on the equity method. (See Chapter 6.) Under the equity method of accounting the investment is carried in the balance sheet at the amount invested, plus the investing company’s share of undistributed operating results.

There are three types of transactions affecting the insurance company’s equity investment in the venture. These are:

1. The actual investment, which is the original contribution to the venture, plus any subsequent contributions;
2. Appreciation or depreciation of the investment, which is the company’s share of the GAAP basis net income or loss of the venture;
3. Withdrawals of the company’s share of the cash flow that is generated by the operations of the venture.

The partnership agreement designates the percentage of distribution of net income and cash flow between the partners. An insurance company’s share of the GAAP net earnings (or losses) of the partnership are reported as investment income in the insurer’s statutory financial statements. The second half of the accounting entry involved is to increase (or decrease) the book value of the partnership. Book value also represents the admitted value reported in the statutory financial statement and may be a negative amount. Cash distributions received reduce the company’s investment (book value) directly and are not reflected as income except where earnings have not been previously reported.

The most recent financial statements of the partnership should generally be used by an investor to apply the equity method. When a lag in reporting exists, intervening events materially affecting the financial position or results of operations of the partnership should be analyzed to determine whether or not the financial statements of the investment should be adjusted. Reporting should be consistent from period to period. If the method of partnership accounting for tax purposes
varies with the accounting for financial reporting purposes, it is necessary that a venture maintain separate accounting records for the areas of difference.

Any contingent commitment to a partnership or joint venture shall be disclosed in the Notes to Financial Statements of the annual statement.

20. The NAIC Annual Statement Instructions provide the following guidance:

**SCHEDULE BA OTHER LONG-TERM INVESTED ASSETS OWNED**

**PARTS 1, 2, AND 3**

Include only those classes of invested assets not clearly or normally includable in any other invested asset schedule. Give a detailed description of each investment and the underlying security. If an asset is to be recorded in Schedule BA, which is normally reported in one of the other invested asset schedules, make full disclosure in Column 1 or a footnote of the reason for recording such an asset in Schedule BA.

If an insurer has any detail lines reported for any of the following required groups, categories, or subcategories, it shall report the subtotal amount of the corresponding group, category, or subcategory, with the specified subtotal line number appearing in the same manner and location as the pre-printed total or grand total line and number:

<table>
<thead>
<tr>
<th>Group or Category</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil and Gas Production</td>
<td>0199999</td>
</tr>
<tr>
<td>Transportation Equipment</td>
<td>0299999</td>
</tr>
<tr>
<td>Mineral Rights</td>
<td>0399999</td>
</tr>
</tbody>
</table>

Fixed or Variable Interest Rate Investments that have the underlying characteristics of:

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>0499999</td>
</tr>
<tr>
<td>Mortgage Loans</td>
<td>0599999</td>
</tr>
<tr>
<td>Other fixed income instruments</td>
<td>0699999</td>
</tr>
</tbody>
</table>

Joint Venture or Partnership Interests that have the underlying characteristics of:

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed income instruments</td>
<td>0799999</td>
</tr>
<tr>
<td>Common Stocks</td>
<td>0899999</td>
</tr>
<tr>
<td>Real Estate</td>
<td>0999999</td>
</tr>
<tr>
<td>Other</td>
<td>1099999</td>
</tr>
<tr>
<td>Surplus Debentures, etc.</td>
<td>1199999</td>
</tr>
<tr>
<td>Any Other Class of Admitted Assets</td>
<td>1299999</td>
</tr>
<tr>
<td>TOTALS</td>
<td>9999999</td>
</tr>
</tbody>
</table>

The following listing is intended to give examples of investments to be included in each category, however the list should not be considered all inclusive and it should not be implied that any invested asset currently being reported in Schedules A, B or D is to be reclassified to Schedule BA:

**Oil and Gas Production**

- Offshore oil and gas leases
Transportation Equipment

Include: Aircraft owned under leveraged lease agreements
        Motor Vehicle Trust Certificates

Mineral Rights

Include: Investments in extractive materials
        Timber Deeds

Fixed or Variable Interest Rate Investments that have the underlying characteristics of a Bond, Mortgage Loan or other fixed income instrument

Include: Fixed income instruments that are not corporate or governmental unit obligations (Schedule D) or secured by real property (Schedule B).

Joint Ventures or Partnership Interests for which the primary underlying investments are considered to be:

Fixed Income Instruments

Include: Leveraged Buy-out Fund
        A fund investing in the “Z” strip of Collateralized Mortgage Obligations
        Mortgage Obligations

Common Stocks

Include: Venture Capital Funds

Real Estate

Include: Real estate development interest

Other

Include: Limited partnership interests in oil and gas production
        Forest product partnerships

Generally Accepted Accounting Principles

21. APB 18 provides guidance on the cost method of accounting for investments in noncontrolled entities. Pertinent paragraphs follow:

3. Several terms are used in this Opinion as indicated:

   a. “Investor” refers to a business entity that holds an investment in voting stock of another company.

   b. “Investee” refers to a corporation that issued voting stock held by an investor.

   c. “Subsidiary” refers to a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50%) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders or by court decree.
d. “Corporate joint venture” refers to a corporation owned and operated by a small group of businesses (the “joint venturers”) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity which is a subsidiary of one of the “joint venturers” is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A minority public ownership, however, does not preclude a corporation from being a corporate joint venture.

DISCUSSION

5. Investments are sometimes held in stock of companies other than subsidiaries, namely corporate joint ventures and other noncontrolled corporations. These investments are usually accounted for by one of two methods—the cost method or the equity method. While practice varies to some extent, the cost method is generally followed for most investments in noncontrolled corporations, in some corporate joint ventures, and to a lesser extent in unconsolidated subsidiaries, particularly foreign. The equity method is generally followed for investments in unconsolidated domestic subsidiaries, some corporate joint ventures and some noncontrolled corporations. An adaptation of the cost method, the lower of cost or market, has also been followed for investments in certain marketable securities if a decline in market value is evidently not a mere temporary condition.

6. A summary of the two principal methods of accounting for the investments in common stock discussed in this Opinion follows:

a. The cost method. An investor records an investment in the stock of an investee at cost, and recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and should accordingly be recognized.

b. The equity method. An investor initially records an investment in the stock of an investee at cost, and adjusts the carrying amount of the investment to recognize the investor’s share of the earnings or losses of the investee after the date of acquisition. The amount of the adjustment is included in the determination of net income by the investor, and such amount reflects adjustments similar to those made in preparing consolidated statements including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between investor cost and underlying equity in net assets of the investee at the date of investment. The investment of an investor is also adjusted to reflect the investor’s share of changes in the investee’s capital. Dividends received from an investee reduce the carrying amount of the investment. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred which is other than temporary and which should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method.
7. Under the cost method of accounting for investments in common stock, dividends are the basis for recognition by an investor of earnings from an investment. Financial statements of an investor prepared under the cost method may not reflect substantial changes in the affairs of an investee. Dividends included in income of an investor for a period may be unrelated to the earnings (or losses) of an investee for that period. For example, an investee may pay no dividends for several periods and then pay dividends substantially in excess of the earnings of a period. Losses of an investee of one period may be offset against earnings of another period because the investor reports neither in results of operations at the time they are reported by the investee. Some dividends received from an investee do not cover the carrying costs of an investment whereas the investor's share of the investee's earnings more than covers those costs. Those characteristics of the cost method may prevent an investor from reflecting adequately the earnings related to an investment in common stock—either cumulatively or in the appropriate periods.

13. Some hold the view that neither the market value method nor the equity method is appropriate accounting for investments in common stock where the investor holds less than majority ownership of the voting stock. They would account for such investments at cost. Under that view the investor is not entitled to recognize earnings on its investment until a right to claim the earnings arises, and that claim arises only to the extent dividends are declared. The investor is considered to have no earnings on its investment unless it is in a position to control the distribution of earnings. Likewise, an investment or an investor's operations are not affected by losses of an investee unless those losses indicate a loss in value of the investment that should be recognized.

OPINION

17. The Board concludes that the equity method of accounting for an investment in common stock should also be followed by an investor whose investment in voting stock gives it the ability to exercise significant influence over operating and financial policies of an investee even though the investor holds 50% or less of the voting stock. Ability to exercise that influence may be indicated in several ways, such as representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Another important consideration is the extent of ownership by an investor in relation to the concentration of other shareholdings, but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor. The Board recognizes that determining the ability of an investor to exercise such influence is not always clear and applying judgment is necessary to assess the status of each investment. In order to achieve a reasonable degree of uniformity in application, the Board concludes that an investment (direct or indirect) of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. When the equity method is appropriate, it should be applied in consolidated financial statements and in parent-company financial statements prepared for issuance to stockholders as the financial statements of the primary reporting entity. 

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7 The equity method should not be applied to the investments described in this paragraph insofar as the limitations on the use of the equity method outlined in footnote 4 would be applicable to investments other than those in subsidiaries.
THE APPlicability of the equity method of accounting

Corporate Joint Ventures

.04 APB Opinion 18 requires investments in corporate joint ventures to be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That opinion applies to corporate joint ventures created to own or operate real estate projects.

.05 Paragraph 3 of APB Opinion 18 states that “an entity which is a subsidiary of one of the joint venturers is not a corporate joint venture.” A subsidiary, according to that opinion, refers to...

...a corporation which is controlled, directly or indirectly, by another corporation. The usual condition for control is ownership of a majority (over 50 percent) of the outstanding voting stock. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Accordingly, an investment in a corporate subsidiary that is a real estate venture should be accounted for by the investor-parent using the principles applicable to investments in subsidiaries rather than those applicable to investments in corporate joint ventures. Minority shareholders in such a real estate venture should account for their investment using the principles applicable to investments in common stock set forth in APB Opinion 18 or in FASB Statement No. 12, Accounting for Certain Marketable Securities.

General Partnerships

.06 The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion 18 in November, 1971, which concludes that many of the provisions of APB Opinion 18 are appropriate in accounting for investments in certain unincorporated entities. The division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume joint and several liability. The division believes, however, that the equity method enables noncontrolling investors in general partnerships to reflect the underlying nature of their investments in those ventures as well as it does for investors in corporate joint ventures. Accordingly, the division believes that investments in noncontrolled real estate general partnerships should be accounted for and reported under the equity method. This recommendation requires the one-line equity method of presentation in both the balance sheet and the statement of income. Paragraph 19 of APB Opinion 18 should be used as a guide in applying the equity method. Investors in general partnerships should provide for income taxes on the profits accrued on their investment in the partnership regardless of the tax basis used in the partnership return. The tax liabilities applicable to partnership interests relate directly to the partners, and the accounting for income taxes generally contemplated by APB Opinion 11 is appropriate. Thus, the differences, if any, between income or loss recorded by a partner under the equity method and the partner’s share of distributable taxable income or loss from the partnership should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

1 Pro rata consolidation is not appropriate except in the limited circumstances described in paragraph .11.

.07 The division believes a general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. APB Opinion 18 states that the usual condition for control of a corporation is ownership of a majority (over 50 percent) of the outstanding voting stock. However, if partnership voting interests are not clearly indicated, a
condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraph .25). The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale or refinancing of principal partnership assets must be approved by one or more of the other partners. The division believes that a controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, intercompany profits and losses on assets remaining within the group should be eliminated. A noncontrolling investor in a general partnership should account for its investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion 18.

Limited Partnerships

.08 The division believes that the accounting recommendations for use of the equity method of accounting for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner’s interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate. Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor’s share of earnings after the date of the investment are applied to reduce the carrying value of the investment. Also, differences between income or losses recognized for financial reporting purposes and the investor’s share of taxable income or losses should be accounted for as timing differences unless they result from tax-exempt revenues or other permanent differences.

.09 The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, if limited partners have important rights, such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, the partnership may not be under the control, directly or indirectly, of the general partnership interests. The division believes that the general partners are in control and should account for their investments in accordance with the recommendations in paragraph .07 only if the substance of the partnership or other agreements provides for control by the general partners.

.10 The division believes that if the substance of the partnership arrangement is such that the general partners are not in control of the major operating and financial policies of the partnership, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest. A controlling limited partner should be guided in accounting for its investment by the principles for investments in subsidiaries. Noncontrolling limited partners should account for their investments by the equity method and should be guided by the provision of paragraph 19 of APB Opinion 18, as discussed in paragraphs .06 and .07, or by the cost method, as discussed in paragraph .08, as appropriate.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, Investments in Subsidiary, Controlled or Affiliated Companies, Chapter 8, Other Admitted Assets
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, Investments in Subsidiary, Controlled or Affiliated Companies, Chapter 8, Other Admitted Assets
- NAIC Annual Statement Instructions, Schedule BA
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

**Generally Accepted Accounting Principles**
- Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stocks*, (APB 18)
- Accounting Interpretation of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stocks* (AIN APB 18), Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
- AICPA Statement of Position No. 78-9, *Accounting for Investments in Real Estate Ventures*

**State Regulations**
- No additional guidance obtained from statutes or regulations.
Statutory Issue Paper No. 49

Policy Loans

STATUS
Finalized March 16, 1998

Type of Issue:
Life Specific

SUMMARY OF ISSUE


2. The purpose of this issue paper is to establish statutory accounting principles for policy loans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. A policy (or contract) loan shall be defined as a loan to a policyholder, under the provisions of an insurance contract, that is secured by the cash surrender value or collateral assignment of the related policy or contract. Policy loans shall include:
   a. Cash loans, including loans resulting from early payment benefits or accelerated payment benefits, on contracts when the terms of the contract specify that such payments are policy loans secured by the policy and
   b. Automatic premium loans, which are loans made in accordance with policy provisions whereby delinquent premium payments are automatically paid from the cash value at the end of the established grace period for premium payments.

4. Policy loans meet the definition of assets defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and meet the criteria for admitted assets, except as specified in paragraphs 6 and 7 of this issue paper. Policy loans are readily available to satisfy policyholder obligations as the terms of the policy loan allow the reporting entity to offset an outstanding policy loan balance against the cash surrender value of the policy.

5. Policy loans shall be carried at the unpaid balance of the loan. The unpaid balance of the loan shall include any unpaid principal plus any accrued interest which is 90 days or more past due.

6. If the unpaid balance of the loan exceeds the cash surrender value or policy reserves established for the policy, the policy generally shall lapse. Cash surrender value shall be defined as the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions. The excess of the unpaid balance of the loan over the cash surrender value shall be evaluated for collectibility. If the amount is considered uncollectible, it shall be written off as a reduction of investment income in the statement of operations during the period it is determined to be uncollectible. Except for collateral assignment loans, all other amounts in excess of the cash surrender value shall be considered nonadmitted assets. The change in this nonadmitted asset shall be recorded as an unrealized capital gain or loss as applicable.
7. A loan resulting from early payment benefits or accelerated payment benefits and secured by an assignment of the policy to the reporting entity as collateral for the loan shall be an admitted asset, except that any loan (including accrued interest) in excess of the policy reserve for that policy shall be nonadmitted. Upon death, the entire death benefit is recorded as a death benefit expense. The policy proceeds shall be used to repay the loan. Any proceeds in excess of that needed to repay the loan are payable to the named beneficiary.

8. Interest income on policy loans shall be recorded as earned and included in investment income consistent with Issue Paper No. 34 - Investment Income Due and Accrued. For interest received before it is earned, unearned interest income shall be recorded as a liability in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

9. Accrued interest income on policy loans that is past due 90 days or more shall be reclassified from Investment Income Due and Accrued and included in the unpaid balance of the policy loan as defined in paragraph 5 above.

DISCUSSION

10. The statutory principles described in the conclusion above are consistent with current statutory guidance except for the following:

   a. The definition of policy loans includes certain early payment benefits or accelerated payment benefits that by the terms of the applicable policy are policy loans. Existing statutory guidance does not specifically address such loans in the guidance on policy loans. The accounting treatment adopted in paragraph 7 above allows a loan resulting from an early payment benefit or an accelerated payment benefit to be an admitted asset if the loan amount plus accrued interest is less than the policy reserve and the loan is secured by the full assignment of the policy benefits to the reporting entity.

   b. Past due interest has been defined in paragraph 9 as accrued interest that is past due 90 days or more.

   c. Under current statutory guidance, the excess of the unpaid balance of the loan over the cash surrender value is a nonadmitted asset. The statutory accounting principle in paragraph 6 above requires different accounting treatment for uncollectible and collectible unpaid balances in excess of the cash surrender value.

11. The statutory accounting principles described in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

   **Conservatism**

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

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

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

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
12. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 7, Policy Loans:

   In most states, the right to make a loan is among the standard provisions that are included in cash value life insurance policies. The policy usually provides:

   1. That the company will advance on the security of the policy an amount which, with interest to either the next policy anniversary or premium due date, will not exceed the guaranteed cash value of the policy on that date;

   2. That any outstanding loan and interest will be deducted from the proceeds;

   3. That interest will be payable annually at either a fixed rate that is specified on the policy or at a variable rate with a description of how the rate is determined;

   4. That interest that is not paid when due shall be added to the loan and shall bear interest at the same rate;

   5. That if the total indebtedness equals or exceeds the cash value, the policy shall terminate; and,

   6. That the policy owner may repay the loan either in whole or in part at any time while the policy is in force.

   In most states, the maximum interest rate on policy loans has been established by statute, although in several states the rate is determined by state insurance departments. Also, some companies have introduced variable interest rates which will reduce the variance in rates between policy loans and other borrowings.

Cash Loans

The request for a cash loan generally will originate with the policy owner in the form of an application for a cash loan. The insured will also be required to sign a loan agreement which specifies the original amount of the loan and may recite all the conditions of the loan. Other parties may also be required to sign the agreement because of contract limitations as to control or because of prior assignment. The agreement to make a cash loan may be made as a special endorsement on the check that the policy owner receives.
Automatic Premium Loans

An automatic premium loan (APL) is one which is made in accordance with the provision in some policies for automatically paying a delinquent premium from the cash value at the end of the grace period. A special loan agreement is not required because the policy owner previously requested the APL option. In some states the policy owner must specifically elect this provision for it to be effective.

The purpose of the APL provision is that, in the event of inadvertent nonpayment of premium or temporary inability to pay the premium, the policy is kept in full force. If the policy were allowed to lapse and the nonforfeiture options of reduced paid-up or extended term insurance were effective, the policy owner would then be required to comply with the reinstatement procedures, such as furnishing evidence of insurability.

Valuation

Policy loans are reported as admitted assets in the statutory financial statement. They are carried at the unpaid balance of the loan provided the unpaid balance does not exceed either the cash surrender value of the policy or the policy reserves. The cash surrender value generally consists of the cash value of the basic policy plus cash value of any policy accumulations such as paid-up additions.

In cases where the policy indebtedness exceeds the cash surrender value, the excess is a nonadmitted asset. The change in this nonadmitted asset is reflected as an unrealized capital gain or loss as applicable.

Interest

Interest on a policy loan may be payable at either the beginning or end of the policy loan interest period. Where it is payable at the beginning of the period, appropriate balance sheet provision should be established for any unearned policy loan interest. Where it is payable at the end of the period, appropriate provision should be established for any accrued interest. Interest earned is reported as investment income.

The calculation of investment income from a company's policy loans requires a determination of unearned or accrued interest. These are included in their respective accounts in the balance sheet as unearned or accrued investment income and not with the balance of policy loans. The calculation of accrued and unearned interest usually is made on a policy-by-policy basis, or for policies grouped by interest rate and policy anniversary or interest paid-to-date.

Past-due interest normally is capitalized as an addition to the loan balance with the interest recorded as received.

13. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance in Chapter 19, Investment Income and Net Realized Gains:

Gross Investment Income

Investment income arises from interest on bonds, dividends on stock, interest on mortgage loans and policy loans, rent on real estate, and other miscellaneous sources. Such income is on a gross basis and does not reflect investment expenses, taxes, depreciation, depletion or interest on borrowed money. Gross investment income is composed of income collected during the period, the change in income due and accrued and the change in income unearned and nonadmitted.
14. The NAIC Annual Statement Instructions provide the following guidance related to Policy Loans:

**EXHIBIT 4 - UNREALIZED CAPITAL GAINS AND (LOSSES) ON INVESTMENTS**

**Line 5 - Premium Notes, Policy Loans and Liens**

Include: In Column 3, the net change in the excess of premium notes, policy loans and other policy assets over net value and other policy liabilities on individual policies. (See Exhibit 14, Line 9.)

**EXHIBIT 13 - ASSETS**

**Lines 5 & 6 - Policy Loans and Premium Notes**

Include: In Column 3 premium notes, policy loans, and other policy assets in excess of net value and of other policy liabilities on individual policies.

Exclude: Interest due and accrued (include in Line 16).

Premium extension agreements (include in Line 14).

Policy liens under reinsurance agreements.

Line 5 plus Line 6, Column 3 should agree with Exhibit 14, Line 9, Column 2.

**EXHIBIT 14 - ANALYSIS OF NON-ADMITTED ASSETS AND RELATED ITEMS**

**Line 9 - Premium Notes, etc., in Excess of Net Value and Other Policy Liabilities on Individual Policies**

The change for the year should be included in Exhibit 4, Column 3, Line 5.

**Generally Accepted Accounting Principles**

15. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies provides the following guidance in Chapter 4, Investment Operations:

**Policy Loans**

4.13 Life insurance companies generally must permit borrowing against the cash values of policies. Policy loans are carried at their unpaid balances including accumulated interest but not in excess of cash surrender values or in excess of policy reserves. Many policy contracts require the company to initiate an "automatic premium loan" to pay delinquent premiums.

* FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, addresses the accounting by creditors for impairment of certain loans. It is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.
It requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loans' observable market price or the fair value of the collateral if the loan is collateral dependent.

The Statement amends FASB Statement No. 5, Accounting for Contingencies, to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with the Statement.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

The Glossary provides the following definitions:

Automatic premium loan - A loan made under a provision in a life insurance policy that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the company if there is sufficient loan value.

Policy loan - A loan made by a life insurance company to a policyholder on the security of the cash surrender value of his policy.

OTHER SOURCES OF INFORMATION

16. NAIC Technical Resource Group Proposed Draft Life Codification provides the following guidance in Chapter 20, Policy and Contract Benefits, related to early payment benefits or accelerated payment benefits:

Early Payment or Accelerated Payment Benefits

When an insurer offers the insured/policyowner an option to receive benefit payments early, typically when the insured is diagnosed with a terminal illness, accounting for the payments must be consistent with the terms of the contract. Either the loan method or policy reduction method shall be used to account for the payments.

Loan Method:

When the terms of the contract recognize payments to be a loan on the policy with the policy serving as collateral, and interest is charged on the loan amount, all payments are reported as policy loans and included as an admitted asset of the insurer. Interest and fees (if any) are recorded when earned. Upon death or lapse (policy loan plus accrued interest equals the face amount), the policy is accounted for as a claim payment.

Policy Reduction Method:

When the payments result in a reduction in the amount of insurance, the payments are recorded as benefit payments with a corresponding release of a pro-rata portion of the policy reserve.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies, Chapter 4, Investment Operations

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
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Statutory Issue Paper No. 50

Classifications and Definitions of Insurance or Managed Care Contracts In Force

STATUS
Finalized June 23, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE


2. GAAP classifies insurance contracts in force as either long-duration or short-duration based on the nature of the insurance enterprise's obligations and policyholder rights under the provisions of the contract. Long-duration contracts include contracts, such as whole life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability and all credit insurance contracts.

3. The purpose of this issue paper is to provide a general framework for classifying insurance or managed care contracts into categories where the recognition of contract and policy reserves and related revenue, benefits, and claims is fundamentally different. Separate issue papers will establish the accounting principles for premium and income recognition and policy benefit and claim reserves for all contracts as defined herein, including comparisons of statutory accounting principles to GAAP.

SUMMARY CONCLUSION

Overview

4. The primary purpose of insurance, including managed care coverage, is to provide economic protection from identified risks occurring or discovered within a specified period. These risks include death, disability, health benefits, outliving one’s financial assets, and damage to property by an insured peril or damage or injury to the insured or third parties. The accounting for these contracts is significantly influenced by the terms of the insurance or managed care contract.

5. In order to provide for a conservative, consistent, and comparable method of accounting for insurance or managed care contracts, premiums and related benefits shall be recognized considering the policy term, premium payment requirements, risks assumed and benefits provided under the contract using conservative assumptions as to interest, mortality, morbidity, and incurred costs for health benefits as applicable. The reserve and income recognition methods reflect the premium payment pattern and the insurance protection and/or benefits provided for in the insurance or managed care contract.
6. This issue paper establishes an overall framework for existing insurance or managed care contracts by identifying four broad categories of insurance or managed care contracts where the premium payment pattern and the protection and/or benefits provided are fundamentally different and therefore require different income recognition and reserving methods.

7. Insurance contracts providing any protection against death, disability, accident or illness in which the reporting entity assumes mortality or morbidity risk shall be classified as life or accident and health contracts, as applicable. Managed care contracts provide defined health care services to subscribers, members or policyholders, collectively referred to hereafter as subscribers, in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period and shall be classified as health contracts. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties, generally over a fixed/limited period of time, shall be classified as property and casualty contracts. Contracts in which the reporting entity does not assume any mortality, morbidity, health benefit costs incurred or casualty risk and which act exclusively as investment vehicles shall be classified as deposit-type contracts. Such classification shall be made at the inception of the contract and shall not change.

**Life Contracts**

8. The primary purpose of life insurance is to provide financial assistance to a beneficiary at the insured’s death. The long period of coverage involving the risk of death, a risk which increases with age, is the distinguishing characteristic by which life insurance is set apart from other forms of insurance. Life insurance is often sold on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services do not occur evenly over the duration of the contract. Premium revenue generally exceeds expected policy benefits in the early years of the contract and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts.

9. The liability for expected costs relating to most types of life contracts is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate and upon the frequency of death derived from mortality tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated at interest. This accumulation, when combined with future net premiums and future investment income theoretically generate a sum sufficient to pay the claims resulting from the death or disabilities of the insured.

10. The liability which corresponds to this fund is referred to as the policy reserve. These contracts are generally expected to be in-force for an extended period of time and require the performance of various functions and services for an undefined period of time and are generally not subject to unilateral changes in their provisions. The policy reserve is generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums, discounted at valuation interest and mortality.

11. Life insurance contracts shall include contracts with life contingencies, including, but not limited to:
   - Whole life contracts
   - Endowment contracts
   - Term life contracts
   - Supplementary contracts
   - Group life contracts
   - Franchise life contracts
   - Universal life type contracts
   - Variable life contracts
Limited payment contracts
Credit life contracts
Annuity contracts

**Accident and Health Contracts**

12. Health insurance policies or managed care contracts, offered by a health maintenance or similar organization, many life insurance and some property and casualty companies, may provide hospital, surgical, medical, loss of income, accidental death and dismemberment, or long-term care coverage as well as other health related benefits. The insurance protection involving economic loss resulting from a medical condition (e.g., medical care expenses or the risk of disability) is the distinguishing characteristic by which accident and health insurance or managed care contracts are set apart from other forms of insurance. Health coverage is currently furnished under group or individual contracts. Coverage sold to individuals can be subdivided according to the reporting entity’s right to continue the policy, limitations on the reporting entity’s right to increase premiums, as well as other factors.

13. Accident and health contracts also include risk contracts with Medicaid and Medicare whereby the reporting entity assumes insurance risk.

14. Managed care contracts are contracts that provide defined health care services to subscribers in return for fixed, periodic premiums (usually paid monthly) that are generally due at or before the beginning of the coverage period. Managed care means a system or technique(s) generally used by reporting entities to affect access to and control payment for health care services. Managed care techniques most often include one or more of the following: 1) review of medical necessity and appropriateness of services or site of services; 2) contracts with selected providers; 3) financial incentives for enrollees to use specific providers, services, or service sites; 4) controlled access to and coordination of services by a case manager; and 5) payor efforts to identify treatment alternatives and modify benefit restrictions for high cost patient care. Expenses for medical, hospital, pharmacy and other benefits are recognized based on the way the reporting entity provides for the contracted services. In some instances, this is through the payment of claims to providers as services are rendered which require a claims liability to be recorded as addressed in Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55) or through capitated arrangements based on contracts with providers, where expense is recognized ratably over the contract period.

15. Similar to life insurance contracts, a significant amount of accident and health contracts is sold to individuals and groups on a level premium basis under which the annual premium remains constant even though the expected policy benefits and services may not occur evenly over the duration of the contract. Premium revenue for level premium contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts.

16. The liability for expected costs relating to accident and health contracts sold on a level premium basis is accrued over the current and expected renewal periods of the contracts. The net valuation premium is based upon an assumed interest rate, persistency, and the frequency of expected death and disability claims generally derived from mortality and morbidity tables. The net premiums collected, after deducting benefits and other costs each year, are accumulated at interest. Similar to life insurance, this accumulation or policy reserve, when combined with future net premiums and future investment income theoretically generate a sum sufficient to pay the claims resulting from the death or disabilities of the insured or subscriber. The reserve is generally calculated as the excess of the present value of future benefits to be paid to or on behalf of insureds or subscribers less the present value of future net premiums, discounted at valuation interest, mortality, and morbidity.
17. Accident and health contracts shall include contracts with health benefits or disability contingencies, including, but not limited to:

- Managed care contracts
- Income replacement contracts
- Expense reimbursement contracts
- Credit accident and health contracts
- Continuing care contracts
- Long-term care contracts
- Accidental death and dismemberment contracts

**Deposit-Type Contracts**

18. Deposit-type or investment contracts do not incorporate insurance risk. Contracts issued by insurers that do not incorporate risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts.

19. Accounting for investment contracts issued by insurance enterprises should be consistent with the accounting for interest-bearing and other financial instruments where the reserve is either based on the accumulated amounts paid plus an income accumulation based on the contract provisions or based on the present value of future benefits, discounted at the applicable interest factor.

20. Deposit-type contracts shall include contracts without life or disability contingencies, including, but not limited to:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Dividend and coupon accumulations
- Annuities certain
- Premium and other deposit funds

**Property and Casualty Contracts**

21. Contracts which insure against damage to property by an insured peril or damage or injury to the insured or third parties shall be classified as property and casualty contracts. Damages shall include both physical and financial damages. Premiums from property and casualty contracts are generally recognized as earned over the exposure period of the contract in proportion to the amount of insurance protection provided.

22. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the duration of the contract. Premiums from property and casualty contracts shall be recognized as earned premium as discussed in Issue Paper No. 53 - Property and Casualty Contracts - Premiums.

23. These contracts shall include but shall not be limited to:

- Traditional property and casualty insurance contracts
- Title insurance contracts
- Mortgage and financial guaranty contracts
DISCUSSION

24. This issue paper establishes an overall framework for existing insurance contracts by identifying four broad categories of insurance contracts where the premium payment pattern and the insurance protection and/or benefits provided are fundamentally different and therefore require different income recognition and reserving methods. The framework established for the purposes of this issue paper differs from the SAP classifications. Additionally, this framework rejects the GAAP classifications (i.e., short-duration and long-duration) found in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97), and FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (FAS 120). However, this framework does incorporate certain elements of both SAP and GAAP. As new types of contracts are developed, based on their characteristics, the contracts can be readily classified into one of the four categories established by this issue paper. Establishing criteria for the evaluation of new products is consistent with the Statement of Concepts which states:

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

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

25. Distinguishing between life, accident and health, deposit-type, and property and casualty contracts is reflective of the insurer’s obligations under the terms of the contract. The common attributes of insurance contracts are often readily identified with the duration of the contract, the insurer’s ability to unilaterally change the terms of the contract, the premium payment pattern, as well as other factors. Based on the attributes, the following general issue papers have been developed:

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<th>Issue Paper</th>
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<td>Life Contracts</td>
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<td>Issue Paper No. 52</td>
<td>Deposit-Type Contracts</td>
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<tr>
<td>Issue Paper No. 65</td>
<td>Property and Casualty Contracts</td>
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26. If additional guidance is necessary, separate issue papers will establish statutory accounting principles for specific insurance contracts as indicated below. Current statutory accounting for specific types of contracts will be evaluated for consistency with the basic concepts established in Issue Paper Nos. 51, 52, 53, 54, and 65, as well as for consistency with the Statement of Concepts. The descriptions of specific types of insurance contracts in paragraphs 2 to 52 of this issue paper are consistent with the descriptions of such contracts found in the AICPA Audits of Property and Liability Insurance Companies
(AICPA P&C Audit and Accounting Guide) and the AICPA Audits of Stock Life Insurance Companies (AICPA Life Audit and Accounting Guide). A summary of those specific issue papers is as follows:

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<tr>
<th>Issue Paper No.</th>
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<td>56</td>
<td>Universal Life-Type Contracts, Policyholder Dividends, and Coupons</td>
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<td>59</td>
<td>Credit Life and Accident and Health Insurance Contracts</td>
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<td>59</td>
<td>Credit Life and Accident and Health Insurance Contracts</td>
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<td>74</td>
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**Property and Casualty Contracts**

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<td>Mortgage Guaranty Insurance</td>
</tr>
<tr>
<td>75</td>
<td>Property and Casualty Reinsurance</td>
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</table>

27. Areas where premium, policy and claim reserves and related areas are accounted for similarly will be combined and discussed as a single topic. Those categories are as follows:

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<tr>
<th>Issue Paper No.</th>
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<tbody>
<tr>
<td>55</td>
<td>Unpaid Claims, Losses and Loss Adjustment Expenses</td>
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<td>Accounting for Retrospectively Rated Contracts</td>
</tr>
<tr>
<td>97</td>
<td>Underwriting Pools and Associations Including Intercompany Pools</td>
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**Life Contracts**

28. The contract for ordinary life insurance is between the company and the policy owner (often the insured). Many variations of ordinary life coverages are available to a purchaser of insurance, including participating, limited-payment periods, combinations of coverages, and decreasing (or increasing) death benefits. Industrial life insurance, also called “debt” insurance, is insurance under which premiums are paid monthly or more often, the face amount of the policy does not exceed a stated amount, and the words “industrial policy” are printed in prominent type on the face of the policy. Ordinary and industrial life insurance contracts are considered life contracts and include the following types of coverage as described in the following paragraphs.

29. **Whole life contracts** provide a fixed amount of insurance coverage over the life of the insured and the related benefits are normally payable only upon the insured's death. Premiums are paid over various periods as allowed by the terms of the policy contract. Whole life insurance contracts provide for nonforfeiture values, some common types being reduced paid up insurance, extended term insurance, and cash values, and some provide for the payment of policy dividends. A level premium is usually paid for policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary life (straight-life) policy stipulates that premiums are to be paid during the life of the insured.

30. **Endowment contracts** are principally savings contracts which incorporate an element of life insurance protection. Endowment insurance contracts provide a benefit if the insured survives the endowment period or the amount is paid to a beneficiary if the insured does not survive. A pure endowment contract only provides a benefit to the insured if he/she survives the endowment period.
Endowment policies mature at a specified attained age of the insured or at the end of a specified period. Premium payments for endowment contracts are made over a specified period, but may also be made under a single premium or limited-payment plan. Both whole life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

31. **Term life contracts** provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to the beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Such policies do not usually provide nonforfeiture values.

32. **Supplementary contracts with life contingencies** are a type of agreement between the insurance company and either the insured or the beneficiary, usually to provide for full or partial settlement of the amount payable upon the termination of an original contract. Generally, the proceeds are paid over the lifetime of one or more beneficiaries. This differs from a supplementary contract without life contingencies under which the proceeds are paid over a definite period without regard to the life of the beneficiary.

33. **Group life contracts** are insurance on the lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold. Group life insurance is based on a master policy which usually precludes or disallows individual selection and is for the benefit of persons other than the policyholder. The individual insured members may receive certificates of insurance which evidence the contract. The contract is made by the policyholder and the insurer; there is no contract of insurance between the policyholder and the members. State statutes vary as to what constitutes a group and as to who may be a policyholder. Some states permit only employee-employer relationships in a group contract. Others permit union members, credit union members, or similar relationships in group contracts.

34. **Franchise life contracts** usually consist of individual policies offered to all persons in a general class (usually a work profession) who are related in some way such as belonging to a certain association.

35. **Universal life and variable life contracts** include those contracts which have terms that are not fixed and guaranteed relative to premium amounts, expense assessments, or benefits accruing to the policyholder. These contracts generally provide for death benefits and nonforfeiture values and may be issued on a fixed premium basis or on a flexible premium basis where the premiums are paid at the insured’s discretion.

36. **Limited-payment contracts** are contracts with terms that are fixed and guaranteed, and for which premiums are paid over a specified number of years or to a specified age. The insurance coverage continues for the remainder of the insured's life. A single-premium policy requires a lump-sum payment at the inception of the policy.

37. **Credit life contracts** are sold in connection with loans or other credit transactions not exceeding a stated duration and provide insurance protection against death. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.
38. An *annuity contract* is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. A contract with a purchase rate guarantee represents a life contingency that would require an annuity contract to be classified as a life contract. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees. The main types of *annuity contracts with life contingencies* are discussed below.

   a. A *deferred annuity* provides for the accumulation of funds to be applied at some future period designated by the policyholder. Premium payments can be made in a lump sum amount (single premium deferred annuity), or periodically (flexible or fixed premium deferred annuity) as allowed by the policy contract. At the end of the accumulation period, the policyholder may elect to receive a lump sum distribution or may elect to receive periodic payments for life, over specific period, or some combination thereof.

   b. A *variable annuity* is an annuity which includes a provision for benefit payments which vary in accordance with the rate of return of the underlying investment portfolio selected by the policyholder. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Premium payments can be made in lump sum amounts, or periodically as allowed by the policy contract. A minimum death benefit is often guaranteed during the annuity consideration accumulation period and these contracts are therefore classified as life contracts.

   c. A *straight-life annuity* provides for periodic payments to the annuitant as long as the annuitant lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.

   d. A *life annuity with a period certain* works essentially the same way as the straight-life annuity as the annuitant receives periodic payments for as long as the annuitant lives. However, if the annuitant dies before the end of the specified “certain” period, payments are continued to a beneficiary until the specified number of “certain” payments (i.e., the specified period in the contract) is completed.

   e. A *refund annuity* is similar to the *life annuity with a period certain* in which the annuitant receives periodic payments for as long as the annuitant lives. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.

   f. A *joint and survivorship annuity* provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

**Accident and Health Contracts**

39. Accident and health contracts provide protection against economic losses resulting from accident, sickness, or medical condition. This coverage may be provided under individual policies, under group or franchise policies, managed care contracts, or Medicaid or Medicare risk contracts, or it may be provided under certain special types of policies, such as credit accident and health insurance.

40. The economic losses which accident and health policies cover, or the types of benefits provided, will vary with different policies. The broad categories of economic losses protected against are medical
and hospital expense and income replacement. For example, payments for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered.

41. Accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health policies.

42. **Credit accident and health insurance contracts** are similar to credit life insurance except the insurance protection is in the form of disability insurance.

43. **Long-term care contracts** represent any contract or policy rider providing coverage for not less than twelve consecutive months for each covered person for one or more necessary diagnostic, preventive, therapeutic, rehabilitative, maintenance or personal care services, provided in a setting other than an acute care unit of a hospital. Under long-term care contracts, the insured event is generally the inability of the contractholder to perform certain activities of daily living as compared to medical contracts which generally provide insurance protection against accident or sickness or disabilities contracts which generally provide income replacement protection.

**Deposit-Type Contracts**

44. Under deposit-type contracts, the policyholder may assume all, some, or none of the investment risk, depending on the contract terms. Amounts can be deposited in lump sum, or periodically as allowed by the policy contract. Deposit-type contracts would include annuities certain, whose income payments have no reference to life contingencies and benefits are paid over a specified period (i.e., 10 years, 20 years, etc.)

**Property and Casualty Contracts**

45. Property and casualty contracts include a variety of types of coverage, including, but not limited to, fire, workers compensation, automobile, multiple peril, professional and miscellaneous liability, and fidelity and surety bonds as further discussed below.

46. Types of insurance represent the perils that are insured by property and liability insurance companies and classified as property and casualty contracts. Some of the more important types of insurance are as follows:

a. **Fire and allied lines**, which include coverage for fire, windstorm, hail, and water damage (but not floods);

b. **Ocean marine**, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. This type of insurance includes inland as well as ocean water transportation;

c. **Inland marine**, which covers property in transit. (It also includes floaters, which are policies that cover movable property, such as a tourist’s personal property);

d. **Workers’ compensation**, which compensates employees for injuries or illness sustained in the course of their employment;

e. **Automobile**, which covers personal injury or automobile damage sustained by the insured and the related liability to third parties for losses caused by the insured;
f. **Multiple peril**, which is a package coverage including most property and liability coverage except workers’ compensation, automobile insurance, and surety bonds;

g. **Professional liability**, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service;

h. **Miscellaneous liability**, which covers most other physical and property damages not included under workers’ compensation, automobile liability, and multiple peril policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property);

i. **Fidelity bonds**, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees; and

j. **Surety bonds**, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.)

47. In addition to these types, insurance is provided by excess and surplus lines. **Excess liability** covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. **Surplus lines** include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

48. Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established **involuntary plans** to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. A common example is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results. Another example of involuntary plans includes Fair Access to Insurance Requirements (FAIR) plans. FAIR plans are federally approved, state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are assessed for any underwriting losses experienced by the FAIR plan.

49. **Medical malpractice pools** were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

50. **Workers’ compensation pools** are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.
51. *Title insurance* insures, guarantees, or indemnifies owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by unidentified instances of defective titles, liens or encumbrances or the unmarketability of the title.

52. *Mortgage guaranty insurance* protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. This type of insurance provides no protection other than against loss due to default.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)**

**Statutory Accounting**

53. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to the classification of life and annuity contracts:

   CHAPTER 10
   AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS

   **Life Insurance**

   All life insurance that is written can be separated into four lines of business: ordinary, industrial, group and credit.

   Ordinary life insurance is the most common type of the four lines, and it may consist of whole life, term, or endowment coverages. The contract is between the company and the insured (or the owner, if different). The payment of the premium by the insured/owner usually is sent directly to the home office of the company and not to a company agent.

   Many modifications of whole life, term, and endowment coverages are available to the insurance buyer. Such variations include limited payment periods, combinations of coverages, and decreasing (or increasing) death benefits. In addition, some policies, notably universal life policies, offer the insurance buyer the option to vary, or even suspend, premium payments over the life of the policy.

   Also considered as ordinary insurance is franchise insurance. It usually consists of individual policies offered to all persons in a general class (usually a work profession) who are related in some way such as belonging to a certain association. Some states require that this relationship be other than through the purchase of insurance.

   Industrial life insurance, also called debit insurance, can be defined as insurance under which premiums are paid weekly, or under which the premiums are payable monthly or more often if the face amount of the insurance provided in the policy does not exceed a stated amount and the words "industrial policy" are printed in prominent type on the face of the policy.

   Group life insurance is insurance on the lives of a group of members, the minimum number of which may be specified by statute. Group insurance is based on a master policy which usually precludes or disallows individual selection and is for the benefit of persons other than the policyholder. The individual insured members may receive certificates of insurance which evidence the contract. The contract is made by the policyholder and the insurer; there is no contract of insurance between the policyholder and the members. The various state statutes vary as to what constitutes a group and as to who may be a policyholder. Some states permit only employee-employer relationships in a group contract. Others permit union members, credit union members, or similar relationships in group contracts.
The fourth line of life insurance is credit. Credit insurance may be either individual or group. All life and all accident and health insurance that is sold in connection with loans or other credit transactions not exceeding a stated duration is to be reported as credit insurance.

54. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to the classification of accident and health contracts:

CHAPTER 13
AGGREGATE RESERVES FOR ACCIDENT AND HEALTH POLICIES

Accident and health insurance provides protection against economic losses resulting from accident and/or sickness. This insurance may be provided under individual policies, under group or franchise policies, or it may be provided under certain special types of policies which bear unique titles such as credit insurance. The economic losses which accident and health insurance policies cover, or the types of benefits provided, will vary with different policies. For example, reimbursement for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered. Therefore, accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health insurance policies.

Accident and health policies are offered by life companies, casualty companies, fraternal benefits societies, and certain specialty companies. While the coverage originated with casualty companies, it is now the life insurance companies which provide the majority of accident and health insurance. The history of the business is important because many of the concepts currently used originated from casualty insurance practices and use casualty terminology. Since the life insurance companies began writing this insurance, the form of the policies and the concept of coverages have changed, which also produced changes in reserving practices.

Individual Accident and Health Policies

Individual accident and health policies, other than credit insurance, are separated for reserve reporting purposes in the statutory financial statement into six classifications. The definitions are included in the instructions for the statutory financial statement and are based principally on the renewal agreement of the policy. There is some variation in the reserve requirements which apply to the different renewal classifications of policies but most reserve requirements apply to all individual policies.

Group Policies

All organizations that qualify to purchase group life insurance may also, by most state laws, purchase accident and health insurance. In many states, the definition of what constitutes an eligible group for accident and health insurance is entirely left up to any set of good underwriting practices established by the insurance company.

Credit Insurance

Credit accident and health insurance is insurance on a debtor to provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled as defined in the policy. Credit policies are limited to issues of 120 months or less in most states. Some states limit such policies to 60 months.
Credit accident and health insurance is sold as either individual or group coverage, and the reserves are included in the annual statement. Because of the significant growth in recent years of credit insurance coverages of 120 months or less are now reported as a separate line of business in the annual statement.

The premium payment methods of credit insurance may be single premium or monthly premium on the outstanding balance. Outstanding balance rates, used only for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness. The premium so determined is remitted on each monthly due date to the insurer by the group creditor. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. Creditors usually remit the single premium for each new insured once a month.

Although credit insurance may be written on an individual or a group basis, the major portion of credit insurance that is written today is group. The two types differ only in form, not in substance. Consequently, they are treated here as one, unless otherwise noted.


**Generally Accepted Accounting Principles**

56. FAS 60, as amended by FAS 120, provides the following guidance on definitions and classification of insurance contracts:

**Summary**

Insurance contracts, for purposes of this Statement, need to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts.

Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer, are recognized when insured events occur.

Premiums from long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur.
INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

   a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

   b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise’s obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.

5. Title insurance contracts provide protection for an extended period and therefore are considered long-duration contracts. Premiums from title insurance contracts ordinarily are recognized as revenue on the effective date of the contract because most of the services associated with the contract have been rendered by that time. Estimated claim costs are recognized when premium revenue is recognized because the insurance provides protection against claims caused by problems with title to real estate arising out of ascertainable insured events that generally exist at that time.

APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock life insurance enterprises, property and liability insurance enterprises, and title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. Except for the sections on premium revenue and...
Classifications and Definitions of Insurance or Managed Care Contracts In Force

INTERNAL Revenue classification and acquisition costs (paragraphs 9-11, 13-18, and 20-31), this Statement applies to mortgage guaranty insurance enterprises. FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts, addresses the accounting for certain long-duration participating life insurance contracts.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

a. Short-duration contract. The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of the premiums charged or coverage provided.

b. Long-duration contract. The contract generally is not subject to unilateral changes in its provisions, such as noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

FAS 97, as amended by FAS 120, provides the following guidance on definitions and classifications of insurance contracts:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.
New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970s. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a "book" of those contracts. Any gain or loss resulting from a policyholder's replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

58. AICPA P&C Audit and Accounting Guide provides the following definitions of types of insurance contracts:

Kinds of Insurance

1.04. Kinds of insurance, generally referred to as lines of insurance, represent the perils that are insured by property and liability insurance companies. Some of the more important lines of insurance are --

- Fire and allied lines, which include coverages for fire, windstorm, hail, and water damage (but not floods).

- Ocean marine, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages. (Ocean marine is perhaps the oldest form of insurance, dating back to at least 600 years to the days of the Venetian traders.)

- Inland marine, which covers property being transported other than transocean. (It also includes floaters, such as for personal property, jewelry, and furs.)

- Workers' compensation, which compensates employees for injuries or illness sustained in the course of their employment.

- Automobile, which covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.

- Multiple peril, which is a package coverage including most property and liability coverages except workers' compensation, automobile insurance, and surety bonds.
- Professional liability, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.

- Miscellaneous liability, which covers most other physical and property damages not included under workers' compensation or automobile liability policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property.)

- Fidelity bonds, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.

- Surety bonds, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits. Surety bonds also include financial guarantees.)

- Accident and health, which covers loss by sickness or accidental bodily injury. (It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.)

1.05. In addition to these lines, insurance is provided by excess and surplus lines. Excess liability covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. Surplus lines include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. Policies are written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

1.06. The lines and premium volume that may be written by a company are generally restricted by state insurance regulations. For example, total written premiums may be limited to a ratio of the company's statutory basis equity. (This and other insurance regulations developed by the National Association of Insurance Commissioners (NAIC) are discussed further in paragraphs 2.05 and 2.06 "NAIC Insurance Regulatory Information System.")

1.07. Insurance written by property and liability insurance companies may be broadly classified as personal lines, which consist of insurance policies issued to individuals, and commercial lines, which consist of policies issued to business enterprises. Personal lines generally consist of large numbers of relatively standard policies with relatively small premiums per policy. Examples are homeowner's and individual automobile policies. Commercial lines involve policies with relatively large premiums that are often retroactively adjusted based on claims experience. The initial premium is often only an estimate because it may be related to payroll or other variables. Examples are workers' compensation and general liability. Many large insurance companies have separate accounting, underwriting, and claim-processing procedures for these two categories.

1.08. Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established programs to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. Following are some of the more common programs that provide the necessary coverage:

- Involuntary automobile insurance. States have a variety of methods for apportioning involuntary automobile insurance. The most widely used approach is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Each automobile insurer operating in the state accepts a share of the undesirable drivers, based on the percent of...
the state's total auto insurance that it writes. For example, a company that writes 5 percent of the voluntary business in a state may be assigned 5 percent of the involuntary applicants. It is then responsible for collecting the premiums and paying the claims on the policies issued to these applicants. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results.

- FAIR plans. FAIR (Fair Access to Insurance Requirements) plans are federally approved, state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are assessed for any underwriting losses experienced by the FAIR plan.

- Medical malpractice pools. These pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.

- Workers' compensation pools. These pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

59. AICPA Life Audit and Accounting Guide, Chapter 3, Insurance Operations, provides the following definitions of types of insurance contracts:

Types of Policies and Contracts

3.02. Policies and contracts usually issued by a life insurance company may generally be designated by the following broad classifications:

1. Life insurance policies.
2. Annuity contracts.
3. Accident and health contracts.

In addition, certain life insurance companies may issue policies which incorporate features of two or three of the broad categories shown above (e.g., an insurance-with-annuity policy). Each of the types of policies is commonly issued both on a participating and on a nonparticipating basis.

3.03. Life Insurance Policies. Life insurance coverage consists of the following basic classes:

1. Whole life.
2. Endowment.
3. Term.
4. Other.

3.04. Whole life policies provide insurance over the insured's entire life and the proceeds (face amount) are paid only upon death of the insured. A level premium is usually paid for policies of this type; and the premium may be paid in annual or more frequent modes. An ordinary-life (straight-life) policy stipulates that premiums are to be paid during the life of the insured. A limited-payment policy is one for which premiums are payable over a stipulated period of time (10,
20, 30 years, etc.). A single-premium policy requires a lump-sum payment at the inception of the policy.

3.05. Endowment policies provide insurance protection over the term of the endowment (i.e., from inception of the policy to the maturity date). Such contracts stipulate payment of the face amount of the policy to a beneficiary if the insured dies during the endowment period. However, if he is still living at the maturity date, the insured will receive the face amount of the policy. Endowment contracts can mature at a specified age of the insured or at the end of a specified period of time. The premiums for contracts of this nature are usually payable over the endowment period, but the premiums can be on a single-payment or limited-payment plan.

3.06. Both whole life and endowment policies contain nonforfeiture or similar clauses which provide for a value in cash or some other form of insurance to be available in the event of failure to continue the required premiums.

3.07. Term policies provide insurance over a specified period of time. If the insured dies during this term, the face amount of the policy will be paid to his beneficiary. Policies for term insurance which are written for relatively short periods of time commonly grant the policyholder the right to renew for an additional period or periods up to a maximum age, such as 60 or 65, without requiring additional evidence of insurability. Rights to convert to whole life or endowment contracts may also be included in the contract. Term contracts may also be made for a period which will end when the insured reaches a certain age (for example, age 60 or 65). Since the premium for term insurance provides for neither maturity benefits nor higher death rates at advanced ages, such policies do not usually accumulate cash surrender values. Collection of premiums for individual insurance may be by mail, where a notice of premium due is sent to the payor, or may be on the debit basis whereby an agent regularly calls at the home of the insured to collect small premium amounts. Usually, the more popular plans of debit life insurance are industrial plans paid up at age 65 or 70 or 10-pay or 20-pay life. Ordinary plans may also be administered on the debit basis.

3.08. In addition to individual policies, life insurance companies offer group life insurance, which insures lives of a group of persons under a single master contract. Insurance of this type is customarily written on a yearly renewable term basis although some permanent group life is sold.

3.09. In addition to the policies and contracts for life insurance mentioned above, there are other life insurance contracts which are becoming more prominent, such as credit life insurance. This form of insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organizations. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan in the form of decreasing term insurance; however, some credit life insurance is sold on a level-term basis.

3.10. In addition to the wide variety of whole life and endowment policies which are available from life insurance companies, the basic policies can be supplemented by the use of riders which are attached to and made a part of the contract. It is fairly common to provide for waiver of premiums through the use of a rider in the event of disability of the insured or for an accidental death benefit. The typical accidental death benefit is often referred to as double indemnity which means that the company will pay twice the amount of the policy if the insured dies through accidental means.

3.11. Annuity Contracts. An annuity contract is an arrangement whereby an annuitant is guaranteed to receive a series of stipulated amounts commencing either immediately or at some future date. Annuity contracts are issued to individuals or to groups. Group annuities are often the vehicle used to provide for a company's pension obligations to its employees.

3.12. The main types of annuities are the following:

3.13. Straight-life annuity -- The straight-life annuity provides for periodic payments to the annuitant as long as he lives. Death of the annuitant constitutes completion of the contract and no further payments are made by the insurance company.
3.14. Life annuity with a period certain -- The life annuity with a period certain works essentially the same way as the straight-life annuity, except that if the annuitant dies before the end of the specified period, payments are continued to a beneficiary until the specified number of payments is completed.

3.15. Refund annuity -- The refund annuity is similar to the annuity certain. There are two variants of this type of annuity. Under the cash refund annuity, a lump-sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. The installment refund annuity provides that annuity payments are to continue to a beneficiary after the death of the annuitant until the sum of all payments made equals the purchase price.

3.16. Joint and survivorship annuity -- The joint and survivorship annuity provides for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.

3.17. Variable annuity -- At present, variable annuities for individuals or groups are being introduced throughout the life insurance industry. A variable annuity is an annuity which includes a provision for benefit payments which vary in accordance with investment experience. The considerations for a variable annuity are usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account before the commencement of annuity payments as well as after. Some variable annuities provide for a guaranteed minimum death benefit during the annuity consideration accumulation period.

3.18. Accident and Health Insurance Contracts. There is a great variety of accident and health contracts which life insurance companies may issue, but most contracts can be generally categorized as follows:

1. Protection against loss of income through partial or total disability.

2. Reimbursement of expenses
   a. Hospital expenses, laboratory services, drugs, and so forth.
   b. Surgical or medical expenses.

3.19. Much of the above coverage is currently being furnished under group contracts. Coverage furnished under individual contracts can be further subdivided according to the insured's right to continue his policy and the limitations on the insurer's right to increase premiums.

60. The AICPA Audit and Accounting Guide: Health Care Organizations provides the following guidance:

Health Care Contracting

1.18 Contracts between a health care provider and a payor based on anything other than full charges requires the provider to accept some financial risk. The nature and degree of risk for the provider varies depending on the contract terms (for example, the definition of the unit of service or the basis for payment). In planning the audit of the health care provider, the auditor considers the audit risk associated with the entity's health care contracts. For example, contracts with payments for services based on a discount from the provider's established rates may have different risks than contracts with payments for services based on a capitated arrangement.

1.19 Generally, capitation payments are made at the beginning of each month and obligate the provider to render covered services during the month. Revenue is earned as a result of agreeing to provide services to qualified beneficiaries and not as a result of actually providing the care. If the provider's accounting system records patient charges and establishes patient receivables as
services are rendered, appropriate valuation allowances or adjustments should be recorded so only the amount of contract revenue is recorded.

1.20 A capitation contract may obligate the provider to assume the risk of physician referrals and other outside services. In this case, a liability for unpaid claims, including incurred but not reported claims, should be established. A lag analysis may be helpful in estimating the liability.

1.21 In addition to the capitation payments, the amount of contract revenue may be affected by factors such as reinsurance recoveries, deductibles, coinsurance, and risk pool adjustments. Risk pool adjustments may be based on factors such as utilization or cost targets.

1.22 Sometimes health care providers enter preferred provider arrangements with self-insured employers whereby the provider guarantees that the employer’s health care cost will not increase over a specified amount or percentage. In substance, these providers may have provided aggregate stop-loss insurance to the self-insured employer, and a material liability to the provider may exist. FASB Statement No. 5, Accounting for Contingencies, provides guidance on accounting for these contingencies. FASB Statement No. 10, Accounting and Financial Reporting for Risk Financing and Related Insurance Issues, provides guidance on accounting for contingencies by governmental enterprises.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 13, Aggregate Reserves for Accident and Health Policies
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies

**Generally Accepted Accounting Principles**

- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- AICPA Audit and Accounting Guide: *Audits of Property and Liability Insurance Companies, Chapter 1, Nature, Conduct, and Regulation of the Business*
- AICPA Audit and Accounting Guide: *Audits of Stock Life Insurance Companies, Chapter 3, Insurance Operations*
- AICPA Audit and Accounting Guide: *Health Care Organizations, Chapter 1, Unique Considerations of Health Care Organizations*

**State Regulations**

- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 51

Life Contracts

STATUS
Finalized March 16, 1998

Type of Issue
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for life contracts as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50) is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 18, Premium Income, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance applies to premiums and considerations and related policy reserves for all contracts with life contingencies. Amounts left on deposit under optional settlement modes and amounts left to accumulate at interest are recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. In addition, policy reserves must make a good and sufficient provision for all unmatured obligations guaranteed under the terms of the contracts and are generally computed based on the provisions of the NAIC Model Standard Valuation Law (SVL), the Actuarial Opinion and Memorandum Model Regulation, the Actuarial Standards of Practice promulgated by the Actuarial Standards Board and the actuarial guidelines adopted by the NAIC; however, variations by state do exist.

2. GAAP guidance for life contracts recognizes premium income when it is contractually due from the policyholder. However, for investment contracts and universal life-type contracts, GAAP requires the consideration received from the policyholder to be treated as a deposit. For limited-payment contracts, GAAP requires that income be recognized over the total benefit period rather than the premium collection period. GAAP guidance also requires policy reserves to be established using actuarial assumptions applicable at the time the insurance contracts are made or, for certain long-duration contracts, the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to establish statutory accounting principles for income recognition and policy reserves for all contracts classified as life contracts as defined in Issue Paper No. 50, except for universal-life type contracts as discussed in Issue Paper No. 56 - Universal Life-Type Contracts, Policyholder Dividends, and Coupons (Issue Paper No. 56) and credit insurance contracts as discussed in Issue Paper No. 59 - Credit Life and Accident and Health Insurance Contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper prescribes the income recognition and general policy reserve requirements for all contracts with life contingencies discussed in Issue Paper No. 50. Also as discussed in Issue Paper No. 50, subsequent issue papers, where needed, will establish specific statutory accounting principles that are applicable to unique characteristics of certain life contracts (e.g., universal life-type, credit life and variable contracts).
Types of Premiums
5. The gross premium is the amount charged to the policyholder and taken into operations as premium income.

6. The net premium is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity’s statutory policy reserves.

7. The difference between the gross premium and the net premium is referred to as ‘loading.’ Loading generally includes allowances for acquisition costs and other expenses but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes.

Premium Income Recognition
8. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract. As a result, premium income shall include first year and renewal premiums, as well as any related premium adjustments (i.e., retrospective premium contracts which are discussed in Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts) provided for by the insurance contract. In addition, single and flexible premium amounts shall also be recorded as premium income when received from the policyholder. Premiums on flexible premium products are discussed in Issue Paper No. 56. The contractual due date shall be established through the predetermined billing procedure agreed to by the parties. Further, the recognition of premium income and the change in loading shall be consistent with the assumptions made in calculating the related policy reserve.

9. Premium income shall include dividends, coupons, guaranteed annual pure endowments, and similar benefits provided by the insurance contract when such amounts are applied by the terms of the contract to provide additional paid-up insurance, annuities, or to shorten the endowment or premium-paying period. Premiums and considerations waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

10. Premium income shall exclude premiums that have been received by the reporting entity prior to the reporting date but which are due on or after the next policy anniversary date (i.e., advance premiums as discussed below).

11. Premium income should be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

12. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded shall be defined and addressed in Issue Paper No. 74 – Life, Deposit-Type and Accident and Health Reinsurance.

13. Death or other benefits used to fund new policies shall be accounted for as a benefit payment and as a new premium, another type of income, or a liability, as appropriate.

Premium Adjustments
14. In the Summary of Operations, the change in gross deferred and uncollected premiums is recorded as premium income. Deferred premiums are further discussed in paragraph 21. Since only the net premiums are included in the computation of reserves and reported as an asset, it is necessary to adjust the gross premium for an amount representing the change in loading on deferred and uncollected premiums. The change in loading is included as an expense in the Summary of Operations and is not shown as a reduction to premium income.
Uncollected Premium Balances
15. Gross premiums that are due and unpaid as of the reporting date, net of loading, shall be classified as uncollected premiums. Uncollected premium balances which are less than 90 days past due meet the definition of assets as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets, and are admitted assets to the extent they conform to the requirements of this paper.

Other Considerations Received
16. Considerations for supplementary contracts, dividends left to accumulate at interest, and amounts deposited and accumulated for guaranteed interest and group annuity contracts shall be recognized as deposit-type funds or considerations for supplemental contracts, as appropriate. These amounts are further discussed in Issue Paper No. 52 - Deposit-Type Contracts.

Policy Reserves
17. Statutory policy reserves shall be established for all unmatured contractual obligations guaranteed under the terms of the policies. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required by Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

18. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Part 9 of the Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

19. The preceding two paragraphs summarize the general reserve requirements for all types of life contracts. In addition to these general reserve requirements, Appendix A-820 provides additional guidance with respect to certain types of accumulation annuities classified as life contracts that have flexible features (e.g., guaranteed nonforfeiture benefits such as interest guarantees, annuitization options, bailout features, partial withdrawals) which can create varying benefit streams if elected by the policyholder. Specific policies with such flexible features covered by this additional guidance include individual and group annuity and pure endowment contracts, but excludes any disability and accidental death benefits in these contracts. For benefits under these contracts, reserves shall be established according to the commissioners’ annuity reserve valuation method (CARVM). Generally, under CARVM, the difference between all possible future guaranteed benefits streams, including guaranteed nonforfeiture benefits, over the future considerations is computed as of the end of each contract year. Each of these differences is discounted to the reporting date at the applicable valuation interest rate. A reserve is then recorded based on the greatest present value difference of each of the contract year calculations.

Valuation (Reserve) Method and Deferred Premiums
20. Reserves shall be established for all benefits guaranteed under the terms of the policy as of the reporting date using appropriate valuation methods, interest, mortality, and morbidity, as appropriate. However, as a practical expedient, reserves have been generally calculated as of the policy anniversary date (i.e., terminal reserves), not the reporting date. As a result, it is necessary to adjust the terminal reserve back to the reporting date. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, full preliminary term, Commissioners Reserve Valuation Method (CRVM), or Commissioners Annuity Reserve Valuation Method (CARVM)). A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.
21. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve must be converted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as described below:

   a. Under the mean reserve method, the policy reserve equals the average of the terminal reserve at the end of the policy year and the initial reserve (the initial reserve is equal to the previous year’s terminal reserve plus the net annual valuation premium for the current policy year). When reserves are calculated on the mean reserve basis, it is assumed that the net premium for a policy is collected annually at the beginning of the policy year and that policies are issued ratably over the calendar year.

   However, as premiums are often received in installments more frequently than annually and since the calculation of mean reserves assumes payment of the current policy year’s entire net annual premium, the policy reserve is overstated by the amount of net modal premiums not yet received for the current policy year as of the valuation date. As a result, it is necessary to compute and report a special asset to offset the overstatement of the policy reserve.

   This special asset is termed “deferred premiums”. Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets shall also be reduced by loading. Since the calculation of mean reserves assumes payment of the current policy year’s entire net annual premium, deferred premium assets are considered admitted assets to compensate for the overstatement of the policy reserve.

   b. Under the mid-terminal method, the policy reserves are calculated as the average of the terminal reserves on the previous and the next policy anniversaries. These reserves shall be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the next policy anniversary date.

Advance Premiums
22. Advance premiums are those premiums that have been received by the reporting entity prior to the valuation date but which are due on or after the next policy anniversary date. The policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums charged to the policyholder may be reduced or discounted to reflect the time value of money. The difference between the gross and discounted premium is ratably charged as interest in the Summary of Operations from the date of payment to the premium due date. At the premium due date, the amount received from the policyholder plus the accumulated interest equals the gross premium necessary to fund the policy. The total amount of such advance premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity’s liability to refund such premiums in the event the policy is terminated.

Reserve Recognition
23. The difference between the policy reserves for life contracts at the beginning and end of the reporting period shall be reflected as the change in reserves in the Summary of Operations, except for any difference due to a change in valuation basis.
Change In Valuation Basis
24. A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits
25. In addition to the basic policy benefit, the insurance contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits and waiver of premium benefits. Appropriate reserves shall be established for these supplemental benefits based on the terms of the contract.

Unearned Income
26. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Accelerated Benefits
27. Accelerated benefits are benefits payable under a life insurance contract to a policyholder or certificateholder during the lifetime of the insured, in anticipation of death or upon the occurrence of specified life-threatening or catastrophic conditions as defined by the policy or rider. These benefits reduce the death benefit otherwise payable under the life insurance contract and are payable upon the occurrence of a single qualifying event which results in the payment of a benefit amount fixed at the time of acceleration. When benefits are provided through the acceleration of benefits under group or individual life policies or riders to such policies, policy reserves shall be determined in accordance with Appendices A-820 and A-822. Reserves for such benefits in the aggregate shall be sufficient to cover policies upon which no claim has yet arisen as well as policies upon which an accelerated claim has arisen. Accounting guidance for accelerated benefit payments made in the form of a loan are addressed in Issue Paper No. 49 - Policy Loans. In addition, accelerated benefit payments, for those accelerated benefits that reduce the policy, shall not be deferred but shall be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Additional Reserves Not Included Elsewhere
28. Additional actuarial liabilities are commonly held for such items as:
   a. Valuation net premiums in excess of gross premiums (i.e., deficiency reserves)
   b. Provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured
   c. Surrender values in excess of reserves otherwise required or carried
   d. Substandard extra premiums, extra mortality on group conversions, and guaranteed insurability options
e. Additional reserves required based on cash flow testing and/or asset/liability matching requirements

f. Additional reserves for policies which contain conversion privileges or future contingent benefits

Disclosures

29. For life and annuity reserves the financial statements shall disclose the following:

a. A description of reserve practices concerning the following:
   i. Waiver of deduction of deferred fractional premiums upon death of insured;
   ii. Return of portion of final premium for periods beyond the date of death; and
   iii. Amount of any surrender value promised in excess of the reserve as legally computed;

b. The methods employed in the valuation of substandard policies;

c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;

d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and

e. The nature of significant other reserve changes.

30. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:
   i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
      (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;
      (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;
   ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in (v.(d)) below;
   iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
iv. Total with adjustment or at market value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;
(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;
(c) In a lump sum subject to a fixed surrender charge of less than 5%;
(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;
(e) All others;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

31. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

a. Industrial business;

b. Ordinary new business;

c. Ordinary renewal;

d. Credit life;

e. Group life;

f. Group annuity.

32. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;
Types of business written;

Type of authority granted (i.e., underwriting, claims payment, etc.);

Total premium written.

33. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

DISCUSSION

SAP Considerations

34. The statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with the Statement of Concepts which states:

Conservatism

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

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

Consistency

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

Recognition

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

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

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).
35. Except as discussed in paragraphs 36 through 41, the statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for life contracts are consistent with current statutory accounting.

**Unearned Income**

36. Unearned income and other similar amounts described in paragraph 26 are not currently addressed in statutory accounting. Unearned income and other similar amounts meet the definition of liabilities as defined in Issue Paper No. 5. Recording unearned income and other similar amounts as deferred income and recognizing the amounts as income only as the earnings process is completed is consistent with the objectives of the Statement of Concepts.

**Cost of Collection Liability**

37. Current statutory accounting requires a liability to be established for the costs of collecting deferred and uncollected premiums in excess of loading when loading is not adequate to cover these costs. As previously discussed, deferred premiums are only recorded when using the mean reserve method and are computed by taking the gross premium extending from the modal premium due date following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. As a result, current statutory accounting requires this liability to be established when using the mean reserve method but not the mid terminal reserve method. Due to the generally conservative nature of the mortality and interest rates prescribed in computing policy reserves, the requirement to establish a liability for the costs of collecting deferred and uncollected premiums in excess of loading has been eliminated. In addition, by eliminating the requirement to establish this liability, the inconsistent practice of requiring this liability to be established when using the mean reserve method as it relates to deferred premiums, but not the mid terminal reserve method has also been eliminated.

**Premium Deficiency**

38. Due to the manner in which the liability for the costs of collecting deferred and uncollected premiums in excess of loading has historically been computed, any deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date were accrued in this liability.

39. As further discussed in Appendix A-820, basic policy reserves are required to be increased in certain circumstances. If in any contract year the gross premium is less than the valuation net premium, the minimum reserve required shall be the greater of

   a. the reserve currently held for the contract or

   b. the reserve calculated by the method currently used but using minimum valuation standards of mortality and interest. The gross premium on the policy is substituted in this reserve calculation at each contract year in which it is less than the valuation net premium.

Although Appendix A-820 makes no explicit reference to deficiency reserves, the excess of reserves described in b) over those described in a) is often referred to as a deficiency reserve.

40. Historically, this calculation has been performed from the next policy anniversary forward. However, since the liability for the cost of collection in excess of loading has been eliminated, which considered deficiencies in gross deferred premiums relative to corresponding net deferred valuation premiums from the valuation date to the next policy anniversary date, this calculation should be performed from the valuation date through the end of the premium paying period.
Accelerated Benefits
41. Current statutory accounting does not address the accounting for accelerated benefits. Consistent with current statutory accounting which requires benefits paid to policyholders to be recorded as an expense in the Summary of Operations and the Statement of Concepts which generally prohibits accounting practices which defer the recognition of expense, this issue paper requires accelerated benefits to be charged to the Summary of Operations as a benefit expense when paid to the policyholder.

Deferred Premiums
42. Reserves for life contracts are generally calculated on the mean reserve basis. Mean reserves are calculated on the assumption that the net premium for a policy is collected annually at the beginning of the policy year. To the extent such premiums have not been collected, reserves calculated on the mean reserve basis overstate the required policy reserve for life contracts. As a result, an adjustment is needed to offset the overstatement of the policy reserve. Historically, this adjustment has been recorded as an asset called “deferred premiums”. For practical reasons related to maintenance, accounting, and financial reporting of reserves for life contracts, these amounts have been reported as assets. As this practice does not affect net income or surplus and considering the importance of consistent financial reporting as well as the anticipated costs and benefits associated with changing this current and pervasive practice, this codification does not change the practice of presenting deferred premiums as admitted assets.

GAAP Considerations
43. Although this issue paper generally reflects the basic accounting for income recognition on life contracts prescribed by GAAP which requires that premiums from life contracts be recognized as income when due from policyholders and that policy reserves be established for the excess of the present value of future benefits and expenses over future net premiums, it rejects the GAAP literature referenced in paragraphs 44 and 45 for the reasons set forth therein.

44. The statutory accounting principles in this issue paper differ from GAAP which specifies different income recognition principles for different types of life contracts. FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97) excludes certain considerations received from premium income on universal life-type contracts and certain limited-payment contracts. For investment and universal life-type contracts, FAS 97 (paragraphs 15 and 19, respectively) recognizes the considerations received as funds on deposit and income is recognized from amounts assessed against policyholders for mortality, contract administration, and surrender charges, as applicable. For limited-payment contracts, FAS 97 (paragraph 16) specifies any gross premium received in excess of the net premium for limited-payment contracts shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts). These differences are inconsistent with the recognition concept in the Statement of Concepts which states that SAP income should reflect the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.

45. FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), FAS 97, FASB Statement 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (FAS 120), AICPA Practice Bulletin No. 8, the AICPA Audits of Stock Life Insurance Companies (AICPA Life Audit and Accounting Guide), and AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises (SOP 95-1) prescribe the following with respect to policy reserves:

a. Specifies that policy reserves represent the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses).
b. Specifies that the liability is estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, terminations, and expenses, applicable at the time the insurance contracts are made. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the “lock-in concept”) unless a premium deficiency exists.

c. Specifies that a premium deficiency exists if the existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs.

d. Requires the retrospective deposit method of accounting for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder.

e. Specifies that the liability for future policy benefits relating to certain participating contracts be equal to the sum of 1) the net level premium reserve for death and endowment policy benefits, 2) the liability for terminal dividends, and 3) any premium deficiency.

46. This issue paper rejects the GAAP literature related to policy reserves referred to in the preceding paragraph, including the excerpts shown in paragraphs 50 to 52 below. These GAAP pronouncements permit the use of generally less conservative assumptions of expected investment yields, mortality, terminations, and expenses applicable at the time the insurance contracts are made and usually produce smaller reserves than current SAP. Current SAP assumptions and estimates are generally more conservative in nature and therefore are more consistent with the objectives in the Statement of Concepts. Further, since the requirements for establishing policy reserves for life contracts are directly related to and are inseparable from the income recognition requirements on both a SAP and GAAP basis, the income recognition requirements of the GAAP literature referenced in this paragraph are similarly rejected in this issue paper.

47. GAAP does not specifically address valuation methods, deferred and uncollected premiums, advance premiums, liability for cost of collection, supplemental benefits, and miscellaneous reserves discussed above. Current practice is to account for these items in a manner similar to SAP but consistent with the GAAP reserve methods used to calculate the basic policy reserve.

Drafting Notes/Comments
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 53 addresses Property Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 56 addresses Universal Life-Type Contracts, Policyholder Dividends, and Coupons.
- Issue Paper No. 59 addresses Credit Life and Accident and Health Insurance Contracts.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.
- Issue Paper No. 89 addresses Separate Accounts.
- No guidance was added from FAS 120, AICPA Practice Bulletin No. 8 or the AICPA Life Audit and Accounting Guide since the guidance was not applicable or was already reflected in FAS 60, FAS 97, and SOP 95-1.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting
48. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance on life policy reserves:

CHAPTER 10
AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS

Life insurance pays the beneficiary on the death of the insured. An endowment pays the policyholder if he lives to the end of the period, or a beneficiary if the policyholder dies. An annuity or pure endowment pays the policyholder if he is living. Policies written today may include numerous provisions, which are either written directly into the policy or attached as a rider.

This chapter discusses the reserves that a company must establish. Aggregate reserves are reported as liabilities in the statutory financial statement.

Statutory Reserves

This type of life insurance policy dictates the amount of the reserve that must be established and how long it must be maintained. Within the ordinary life and industrial line of business, there are three basic types of policies: whole life, endowment, and term. (Annuities and pure endowments are discussed later in this chapter.)

Whole life insurance provides coverage for the life of the insured as long as the premiums are paid in conformity with the policy. Under a whole life plan of insurance, the company is obligated to maintain a reserve until the death of the insured.

Term life insurance provides coverage only for the period that is specified in the policy. Under a term insurance plan, the company maintains a required reserve which reduces to zero upon expiration of the term period.

Similar to term insurance, endowment life insurance provides coverage for a period specified in the policy. Unlike term insurance, the proceeds of endowment insurance are payable if the insured lives to the end of the period.

In the aggregate, policy reserves for all life insurance policies that are reported in the statutory financial statements must equal or exceed reserves calculated by using certain assumptions and methods that produce the minimum required by law. Further, each state requires a Statement of Actuarial Opinion which provides the opinion of an actuary that aggregate reserves make good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies and meet the minimum requirements of the laws of the state of domicile.

Minimum Reserves Required

The components necessary to compute reserves are an interest rate, a mortality table, and a method of valuation. The standards for determining the minimum statutory reserves that are required in life insurance policies are prescribed in statutes or regulations. Generally, the states follow the provisions of the NAIC Model Valuation Law and its interpretations; however, variations by state do exist.
These standards vary by line of business and by issue date of the policy. Further limitations are placed on policies having nonforfeiture benefits.

Types of Reserves

The reserves calculated for a block of life insurance policies as of the valuation date may be based upon different assumptions concerning the anniversary (issue) date and the average date when premiums are due. The different types of reserves that may be used are terminal, initial, mid-terminal, and mean.

The terminal reserve is the policy reserve at the end of the policy year. It is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

The initial reserve is the previous year’s terminal reserve plus the net valuation premium for the current policy year. This reserve basis is not frequently utilized in financial reporting.

In computing reserves on ordinary insurance, most companies use mean reserves. These are defined as the average of the initial and terminal reserves for the current year, on the assumption that policies are issued uniformly throughout the calendar year on an annual premium basis. Any fractional premium (e.g., monthly, quarterly, semiannual) for the current policy year which is not yet due must be reported as a deferred premium.

Mid-terminal reserves are generally used to value industrial insurance, on which premiums are usually paid monthly or weekly. Mid-terminal reserves are the average of the terminal reserves on the last and the next policy anniversaries. These reserves must be accompanied by an unearned premium reserve consisting of the portion of valuation premiums paid or due covering the period from the valuation date to the due date of the next modal premium. Any premiums due beyond the valuation date but paid prior to that date are included in the advance premium liability.

Certificates of fraternal benefit societies generally are reserved on a mid-terminal basis.

Reserves for permanent group life insurance plans usually are calculated in the same way as individual insurance and can be either mean (with deferred premium) or mid-terminal plus the unearned premium.

Supplemental Benefits

In addition to the basic death benefit, life insurance policies may provide other benefits. These supplemental benefits are sold for additional premiums or for a basic premium that has been calculated to include their costs. In either case, the company must establish appropriate reserves for these benefits. Examples of reserves for these benefits include:

1. Accidental death benefits. The most common additional death benefit is double indemnity which provides for an additional payment equal to the face amount of the policy in the event of accidental death. Triple indemnity also is offered, but it usually is limited to accidental death in connection with commercial travel.

2. Total and permanent disability benefits - active lives. It is common for a life insurance policy to be sold with an additional benefit for waiver of premiums upon the disability of the policyowner. This is called waiver of premiums benefit. The company, of course, must establish a reserve for waiver of premium benefits.

A benefit rider for disability payments to the policyowner/insured also may be attached to a life insurance policy.

3. Total and permanent disability benefits - disabled lives. In the event of a waiver of premiums or payment of benefits due to total and permanent disability, a reserve must be established to cover the present value of the future gross premium to be waived or the
payments to be paid. Policies on which benefits are currently being paid are called disabled lives. For ordinary contracts this reserve usually is reported as a part of the aggregate life reserves. This is in addition to the basic policy reserve for active lives.

Miscellaneous Reserves

Since the actuarial liabilities must include provision for any contingent benefit or right which may arise, statutory statements provide for estimates of a number of miscellaneous reserve items. For example, state laws or regulations may require minimum reserves when valuation net premiums exceed gross premiums. The additional reserve needed to meet the minimum may appear separately as a miscellaneous reserve or may be included with the life reserve in accordance with the applicable state regulations. Similarly, provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured may be made as a separate reserve or as part of the life reserve. Approximate reserving methods are accepted and frequently used to estimate such items. Another minimum reserve which must be provided for is a reserve for surrender values in excess of reserves otherwise required or carried. There are other miscellaneous items commonly encountered, such as reserve for substandard extra premiums, a reserve for extra mortality on group conversions, and reserve for guaranteed insurability options.

Changes in Valuation Bases

Where the interest rate, mortality basis, reserving method (e.g., net level, preliminary term, etc.), or other basis affecting reserve computation of in force business is changed during the year, any increase or decrease in actuarial reserves resulting from this change in valuation basis must be charged directly to surplus rather than as a part of the reserve increase item in the summary of operations. For various reasons, any change in valuation bases which produces an increase in reserves (reserve strengthening) or decrease in reserves (reserve destrengthening) may require the approval of the applicable regulatory authority. Procedures and timing for such approval vary from state to state.

49. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to premium income recognition:

CHAPTER 18
PREMIUM INCOME

Premiums are generally recorded in the company’s general ledger when received. This necessitates adjustments as of the balance sheet dates for premiums received in advance of their due date, for premiums which are due but have not yet been received, and for “deferred” premiums. Premium income reported in the Summary of Operations includes reinsurance assumed and is reduced by reinsurance ceded.

Deductions should be made for premiums and annuity considerations returned and allowances to industrial policyholders for direct payment of premiums. Commissions and allowances on reinsurance premiums assumed and ceded may not be deducted.

Single premiums and considerations include dividends, coupons, guaranteed annual pure endowments, and similar benefits applied to provide paid-up additional insurance or annuities. Renewal premiums collected are to include dividends and coupons applied to pay renewal premiums and to shorten the endowment or premium-paying period.

Premiums and considerations waived by the company under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.
**Gross and Net Premiums and Loading**

A “gross” premium is the amount charged to the policyholder and taken into operations as premium income. A “net” premium is the amount calculated on the basis of the interest and mortality table used to calculate the insurance company's policy reserves.

The difference between the gross and net premium is called “loading.” Loading is an amount of the gross premium that provides the company with the funds to pay commissions, to meet operating expenses, to provide for contingencies, and to return a profit.

**Deferred and Uncollected Premiums**

The increase in reserves for life insurance policies which is charged against operations for the year is based on reserves frequently calculated on what is called the mean reserve basis. Mean reserves are calculated on the assumption that the entire annual premium for a policy is collected annually at the beginning of the policy year.

However, since premiums are often received in installments more frequently than annually and since the mean reserves assume payment of the current year’s net annual premium, it becomes necessary to compute and report a special asset item to offset the additional liability. This asset item is termed “deferred premiums.” It represents the premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date. The company, therefore, reports deferred premiums not yet due as premium income “gross” and as an asset net of loading. Policies with premiums payable annually on the policy anniversary will not have deferred premiums.

Since the policy reserve liability calculated on the mean reserve basis assumes the collection of premiums to the following policy anniversary, deferred premiums (semiannual, quarterly, or monthly premiums due in the following year prior to the anniversary date) which have been collected in the current year reduce the deferred premium asset. The liability for advance premiums would consequently exclude such premiums.

Life insurance premium income also includes, on a gross basis, those premiums that have been billed and are due and unpaid on the valuation date. An asset item is allowable for any such uncollected premiums net of loading. Theoretically, only policies in their grace period would have uncollected premiums at the balance sheet date because policies beyond the grace period would have been lapsed. However, in actual practice most companies, to avoid processing a large number of transactions in the first month or so after the grace period, may not process policies with uncollected premium until 30 to 60 days after expiration of the grace period. These policies, therefore, may still be shown and valued as being premium-paying.

The amount of deferred and uncollected premiums that should be reported as an asset is the aggregate of the related net premiums because the sole purpose of the asset is to offset the net premium included in the policy reserves. If the company reported gross premiums deferred and uncollected as an asset, it would be required to provide an offset for the amount of loading for expenses and profits that have not yet been incurred or realized.

Net premiums deferred and uncollected may be determined in one of two ways. Either a seriatim listing of gross and net premiums may be prepared or the company may calculate ratios of net to gross premiums deferred and uncollected. In this second case, the company must be able to support its factors with studies that consider the mix of business, the amounts applicable first year and renewal premiums, and so forth. In any case, the company should be able to demonstrate that the net premiums are the same as those used in the calculation of the reserves.

In the Summary of Operations the change in gross deferred and uncollected premiums is taken in as premium income. Since only the net premiums are included in reserves and reported as an asset, it is necessary to make an adjustment for the change in the loading on deferred and uncollected premiums.
Cost of Collection in Excess of Loading

A liability should be provided for the cost of collection on premiums and annuity consideration deferred and uncollected in excess of total loading thereon if the company deems the loading to be inadequate. The increase in this item and the increase in loading on deferred and uncollected premiums are both recorded in the same line in the Summary of Operations. Provisions for cost of collection should include commissions, collection fees, and taxes contingent upon the collection of the deferred and uncollected premiums.

Premiums Received in Advance

Premium income reported in operations must exclude premiums that have been received by the company prior to the valuation date but which are due on or after the next policy anniversary date. The accounting treatment is the same for both life and accident and health premiums.

A policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums may be discounted for interest from their due dates to the date of payment. The total amount of such gross premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement. The gross premium less any discount is recorded as the advance premium, not the net valuation premium, in recognition of the company's liability to refund such premiums in the event the policy is terminated.

Advance premiums must be recorded for industrial as well as ordinary and group policies. Advance premiums received on group policies may be reported in the liability for premiums received in advance or as a 100% unearned premium reserve.

Premium and Other Deposit Funds

A company may also receive premiums over one year prior to their due date and include them in a premium deposit fund. These amounts are not reported as income. The premium deposit fund may or may not represent payment of specific future premiums. Interest at contracted rates is credited annually to each individual account. Interest on such funds must be accrued to the balance sheet date. The terms of the fund (interest rate, disposition, and so forth) are specified in the provisions of the policy or in a separate endorsement. An explanation of other deposit funds can be found in Chapter 12.

Amounts deposited and accumulated for guaranteed interest contracts may be included in this classification. Finally, other deposit items of a generally similar nature may also be included herein.

Withdrawals from deposit accounts to pay premiums are credited to the appropriate income account. Provision is made in the statutory financial statement for reporting the balance of such deposits as of the balance sheet date.

Industrial Policies

Mid-terminal reserves are generally held for industrial insurance policies. Because of the collection of premiums due after the statement date and up to the next policy anniversary is not assumed in the calculation of mid-terminal policy reserves, no deferred premium asset is recorded and no deferred premiums are taken into operations as premium income.

Uncollected premiums due on industrial policies are defined in the same way as uncollected ordinary premiums and are bound by the same limitations. For industrial policies on which an asset is recorded for uncollected premiums, reserves should be established on the same basis as for those where the premiums have been collected and such uncollected premiums are taken into operations as premium income.
Group Life Policies

Group term policies generally carry unearned premium or one-year term insurance reserves and where premiums are accounted for on a true monthly premium basis no deferred premium asset would generally be appropriate. However, where premiums are accounted for on an annual premium basis and payable in installments more frequently than annually, it would be appropriate to take deferred premiums into premium income and to set up a net deferred premium asset, based on the valuation standards used, together with an appropriate addition to reserves.

Uncollected premiums are allowed as an asset and should be recorded net of loading. The corresponding reserve liabilities must reflect the uncollected premiums that are taken as an asset.

Group permanent policies may have deferred and uncollected premiums if reserves are calculated on a mean basis. They may have only uncollected premiums if reserves are calculated on a mid-terminal basis.

Annuity Contracts

Certain annuity contracts, usually group pension contracts, frequently provide for the payment to the company of amounts other than premiums or considerations to be accumulated at interest for the purpose of providing pensions for employees at retirement and similar benefits. Amounts withdrawn from the fund to purchase annuity benefits reduce “Annuity and other fund deposits” and increase premium and annuity considerations.

Uncollected and deferred annuity considerations are calculated on deferred annuity contracts other than single payment contracts. The asset item is recorded net of loading.

Considerations for Supplementary Contracts

The Summary of Operations includes as income all policy proceeds which have been left with the company during the year under optional modes of settlement to provide beneficiaries or the policyowner with periodic income under a supplementary contract. Supplementary contracts may provide for an income payable for the lifetime of the payee(s), in which case the considerations would be reported as “Considerations for supplementary contracts with life contingencies.” A supplementary contract may also provide for the payment of a periodic income for a specified number of years or for payments of a specified amount until the funds with interest earnings are exhausted. The considerations for such supplementary contracts are reported separately as “Considerations for supplementary contracts without life contingencies.”

These considerations arise from proceeds retained at death, disability, surrender, or maturity of policies and annuity contracts. The amount of these retained proceeds is included in the amount reported in the Summary of Operations for policy and contract benefits.

Considerations for Dividend Accumulations

Another income item in the Summary of Operations is “Consideration for dividend accumulations.” The accounting treatment for dividend accumulation deposits, dividend accumulation payments, and the change in the liability is similar to accounting for life insurance. Consideration for dividend accumulations represents the amount of policy dividends left on deposit with the company during the year to accumulate at interest. This amount would normally agree with the amount reported in the Dividends and Coupons to Policyholders exhibit of the annual statement as being left on deposit with the company.

**Generally Accepted Accounting Principles**

50. FAS 60, as amended by FAS 97 and FAS 120, provides the following guidance related to income recognition and related policy reserves for life and accident and health contracts:
Insurance contracts, for purposes of this Statement, need to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts.

Premiums from long-duration contracts are recognized as revenue when due from policyholders. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future new premiums to be collected from policyholders are accrued when premium revenue is recognized. Those estimates are based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. Claim costs are recognized when insured events occur.

INTRODUCTION

1. The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

   a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

   b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

2. Two methods of premium revenue and contract liability recognition for insurance contracts have developed, which are referred to as short-duration and long-duration contract accounting in this Statement. Generally, the two methods reflect the nature of the insurance enterprise’s obligations and policyholder rights under the provisions of the contract.

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

4. Premiums from long-duration insurance contracts, including many life insurance contracts, generally are level even though the expected policy benefits and services do not occur evenly over the periods of the contracts. Functions and services provided by the insurer include insurance protection, sales, premium collection, claim payment, investment, and other services. Because no single function or service is predominant over the periods of most types of long-duration contracts, premiums are recognized as revenue over the premium-paying periods of the contracts when due from policyholders. Premium revenue from long-duration contracts generally exceeds expected policy benefits in the early years of the contracts and it is necessary to accrue, as premium revenue is recognized, a liability for costs that are expected to be paid in the later years of the contracts. Accordingly, a liability for expected costs relating to most types of long-duration contracts is accrued over the current and expected renewal periods of the contracts.
APPLICABILITY AND SCOPE

6. This Statement establishes accounting and reporting standards for the general-purpose financial statements of stock life insurance enterprises, property and liability insurance enterprises, title insurance enterprises, mutual life insurance enterprises, assessment enterprises, and fraternal benefit societies. Except for the sections on premium revenue and claim cost recognition and acquisition costs (paragraphs 9-11, 13-18, and 20-31), this Statement applies to mortgage guaranty insurance enterprises. FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts, addresses the accounting for certain long-duration participating life insurance contracts.

* The accounting for certain long duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.

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2 Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

10. Premiums from long-duration contracts shall be recognized as revenue when due from policyholders. A liability for expected costs relating to most types of long-duration contracts shall be accrued over the current and expected renewal periods of the contracts. The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders (liability for future policy benefits) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. In addition, liabilities for unpaid claims and claim adjustment expenses shall be accrued when insured events occur.

Liability for Future Policy Benefits

21. A liability for future policy benefits relating to long-duration contracts other than title insurance contracts (paragraph 17) shall be accrued when premium revenue is recognized. The liability, which represents the present value of future benefits to be paid to or on behalf of policyholders and related expenses less the present value of future net premiums (portion of gross premium required to provide for all benefits and expenses), shall be estimated using methods that include assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. The liability also shall consider other assumptions relating to guaranteed contract benefits, such as coupons, annual endowments, and conversion privileges. The assumptions shall include provision for the risk of adverse deviation. Original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits (often referred to as the “lock-in concept”) unless a premium deficiency exists (paragraphs 35-37). Changes in the liability for future policy benefits that result from its periodic estimation for financial reporting purposes shall be recognized in income in the period in which the changes occur.

Investment Yields

22. Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are made. The interest assumption for each block of new insurance contracts
(a group of insurance contracts that may be limited to contracts issued under the same plan in a particular year) shall be consistent with circumstances, such as actual yields, trends in yields, portfolio mix and maturities, and the enterprise’s general investment experience.

Mortality

23. Mortality assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected mortality.

Morbidity

24. Morbidity assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected incidences of disability and claim costs. Expected incidence of disability and claim costs for various types of insurance (for example, noncancelable and guaranteed renewable accident and health insurance contracts) and other factors, such as occupational class, waiting period, sex, age, and benefit period, shall be considered in making morbidity assumptions. The risk of antiselection (the tendency for lower terminations of poor risks) also shall be considered in making morbidity assumptions.

Terminations

25. Termination assumptions used in estimating the liability for future policy benefits shall be based on anticipated terminations and nonforfeiture benefits, using anticipated termination rates and contractual nonforfeiture benefits. Termination rates may vary by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors. If composite rates are used, the rates shall be representative of the enterprise’s actual mix of business. Termination assumptions shall be made for long-duration insurance contracts without termination benefits because of the effects of terminations on anticipated premiums and claim costs.

Expenses

26. Expense assumptions used in estimating the liability for future policy benefits shall be based on estimates of expected nonlevel costs, such as termination or settlement costs, and costs after the premium-paying period. Renewal expense assumptions shall consider the possible effect of inflation on those expenses.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise’s manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Long-Duration Contracts

35. Original policy benefit assumptions for long-duration contracts ordinarily continue to be used during the periods in which the liability for future policy benefits is accrued (paragraph 21). However, actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts and (b) to recover unamortized acquisition costs. In those circumstances a premium deficiency shall be determined as follows:

Present value of future payments for benefits and related settlement and maintenance costs, determined using revised assumptions based on actual
and anticipated experience  $XX

Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience  XX

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Liability for future policy benefits using revised assumptions  XX

Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs  XX

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Premium deficiency  $XX

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36. A premium deficiency shall be recognized by a charge to income and (a) a reduction of unamortized acquisition costs or (b) an increase in the liability for future policy benefits. If a premium deficiency does occur, future changes in the liability shall be based on the revised assumptions. No loss shall be reported currently if it results in creating future income. The liability for future policy benefits using revised assumptions based on actual and anticipated experience shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date.

37. A premium deficiency, at a minimum, shall be recognized if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognized in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset the losses that would be recognized in later years.

51. FAS 97, as amended by FAS 120, provides the following guidance on premium income recognition:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not addressed by FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970’s. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross
profit amounts from the operation of a “book” of those contracts. Any gain or loss resulting from a policyholder’s replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

INTRODUCTION

1. FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, issued in June 1982, contains specialized accounting principles and practices based on AICPA insurance Industry Audit Guides and Statements of Position. Statement 60 identifies but does not address a number of areas that were being studied by the insurance industry and the accounting and actuarial professions when that Statement was issued. One of those areas is the accounting for universal life insurance and similar products that were developed after the issuance of the AICPA Guides and Statements of Position.

2. Statement 60 describes two methods of premium revenue and contract liability recognition, referred to as long-duration and short-duration contract accounting. Each method is designed to reflect the insurance enterprise’s obligations and policyholder rights under the provisions of the contract. The insurance contracts addressed in this Statement are generally considered long-duration insurance contracts.

3. Recognition of premiums as revenue when due from policyholders and measurement of a liability for policyholder benefits based on a uniform percentage of anticipated premiums are distinguishing features of the accounting for long-duration insurance contracts specified in Statement 60. Because no single function or service is predominant over the periods of most long-duration insurance contracts, recognition of premiums as revenue over the premium-paying periods was considered a reasonable measure of service performed.

4. The differences between universal life insurance and the long-duration contracts described in Statement 60 led many to question the propriety of applying the accounting method described in Statement 60 to universal life insurance. Universal life insurance contracts lack the fixed and guaranteed terms that are typical for the contracts for which the accounting specified in Statement 60 was designed. Policyholders are frequently granted significant discretion over the amount and timing of premium payments. Insurers are frequently granted significant discretion over amounts that accrue to and that are assessed against policyholders.

5. Some long-duration insurance contracts that are addressed by Statement 60 have terms that are fixed and guaranteed but lack either the level premiums or the insurance protection characteristics contemplated in Statement 60. The increasing number of those contracts led the Board to reconsider the accounting for them at the same time it considered the accounting for universal life insurance.

APPLICABILITY AND SCOPE

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as investment...
contracts, limited-payment contracts, and universal life-type contracts. The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60 and FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

8. Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote\(^1\) or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant\(^2\).

\(^1\) The term remote is defined in paragraph 3 of FASB Statement No. 5, Accounting for Contingencies, as “the chance of the future event or events occurring is slight.”

\(^2\) Webster’s New World Dictionary, Second College Edition, defines the term insignificant as “having little or no importance; trivial.”

9. Long-duration insurance contracts with terms that are fixed and guaranteed, and for which premiums are paid over a period shorter than the period over which benefits are provided, are referred to in this Statement as limited-payment contracts. The period over which benefits are provided, as used in this Statement, includes the periods during which the insurance enterprise is subject to risk from policyholder mortality and morbidity and during which the insurance enterprise is responsible for administration of the contract. The benefit period does not include the subsequent period over which the policyholder or beneficiary may elect to have settlement proceeds disbursed.

10. Except as provided in paragraph 11 [not excerpted], long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as universal life-type contracts. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one of the following features:

a. One or more of the amounts assessed by the insurer against the policyholder -- including amounts assessed for mortality coverage, contract administration, initiation, or surrender -- are not fixed and guaranteed by the terms of the contract.

b. Amounts that accrue to the benefit of the policyholder -- including interest accrued to policyholder balances -- are not fixed and guaranteed by the terms of the contract.

c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.
STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Limited-Payment Contracts

16. Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

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3 Statement 60 defines gross premium as “the premium charged to a policyholder for an insurance contract.” That Statement defines net premium as “the portion of the gross premium required to provide for all benefits and expenses.”

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Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

   a. The balance that accrues to the benefit of policyholders at the date of the financial statements

   b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)

   c. Any amounts previously assessed against policyholders that are refundable on termination of the contract

   d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.
20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, are unearned revenues.

Other Amendments to Statement 60

29. This Statement adds the following footnote to paragraph 6 of Statement 60:

*The accounting for certain long-duration insurance contracts referred to as investment contracts, limited-payment contracts, and universal life-type contracts is established by FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments.

30. Paragraph 15 of Statement 60 is superseded by the following:

Premiums from long-duration contracts, such as whole-life contracts, guaranteed renewable term life contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

52. AICPA Statement of Position No. 95-1, Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises, provides the following guidance on premium revenue recognition and policy reserves:

12. Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Liability for Future Policy Benefits

15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of --

a. The net level premium reserve for death and endowment policy benefits.

b. The liability for terminal dividends.

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.

16. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values -- as set by the National Association of Insurance Commissioners' (NAIC) model standard nonforfeiture law--for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:  

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated.
If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)

18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 18, Premium Income
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force

**Generally Accepted Accounting Principles**
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- AICPA Statement of Position 95-1, *Accounting for Certain Activities of Mutual Life Insurance Enterprises*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*
- AICPA Practice Bulletin 8, Application of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

**State Regulations**
- No additional guidance obtained from state statutes or regulations. State regulations may be excerpted and discussed, as necessary, in subsequent issue papers dealing with unique aspects of specific life contracts.
Statutory Issue Paper No. 52

Deposit-Type Contracts

STATUS
Finalized March 16, 1998

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for deposit-type contracts, as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50) is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 12, Deposit Funds and Other Liabilities Without Life or Disability Contingencies, and Chapter 18, Premium Income of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance applies to premiums, deposit-type funds, and considerations as well as related policy reserves for all life, annuity, deposit, and other similar contracts with and without life contingencies. Under current statutory accounting, considerations on deposit-type contracts are generally recorded as income in the Summary of Operations when received as either annuity considerations, deposit-type funds, considerations for supplemental contracts without life contingencies and dividend accumulations, or coupons left to accumulate at interest, as appropriate. In addition, policy reserves must make a good and sufficient provision for all unmatured obligations guaranteed under the terms of the contracts and are generally computed based on the provisions of the NAIC Model Standard Valuation Law (SVL), the Actuarial Opinion and Memorandum Model Regulation, the Actuarial Standards of Practice promulgated by the American Academy of Actuaries, and the actuarial guidelines adopted by the NAIC; however, variations by state do exist.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, and annuity contracts, that are expected to remain in force for an extended period. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are classified as investment contracts and are accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments (i.e., the balance that accrues to the benefit of the policyholder). Payments received on those contracts are not reported as revenue.

3. The purpose of this issue paper is to establish statutory accounting principles for income recognition and policy reserves for deposit-type contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. As discussed in Issue Paper No. 50, deposit-type contracts are those contracts that do not subject the reporting entity to any risks arising from policyholder mortality or morbidity. A mortality or morbidity risk is present if, under the terms of the contract, the reporting entity is required to make payments or forego required premiums contingent upon the death or disability (in the case of life and disability insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals.
5. As in universal life-type contracts, as discussed in Issue Paper No. 56 - Universal Life-Type Contracts, Policyholder Dividends, and Coupons, deposit-type contracts frequently grant policyholders significant discretion over the amount and timing of deposits and withdrawals. Reporting entities are frequently granted significant discretion over amounts that accrue to or that are assessed against policyholders.

6. Due to the absence of mortality and/or morbidity risk and the discretionary characteristics noted in the preceding paragraph, the accounting principles for income recognition and policy reserves for deposit-type contracts differ from the accounting for life contracts set forth in Issue Paper No. 51 - Life Contracts (Issue Paper No. 51), accident and health contracts established in Issue Paper No. 54 - Individual and Group Accident and Health Contracts, and credit insurance contracts as discussed in Issue Paper No. 59 - Credit Life and Accident and Health Insurance Contracts.

7. This issue paper prescribes the income recognition and policy reserve requirements for all contracts without life or disability contingencies. Contracts that generally do not subject the reporting entity to risks arising from policyholder mortality or morbidity include, but are not limited to certain types of the following policy categories:

- Supplemental contracts
- Lottery payouts
- Structured settlements
- Guaranteed interest contracts
- Income settlement options
- Annuities certain
- Dividend and coupon accumulations
- Premium and other deposit funds

As discussed in Issue Paper No. 50, subsequent issue papers, where needed, will establish specific statutory accounting principles that are applicable to unique characteristics of certain deposit-type contracts (e.g., separate accounts).

**Income Recognition**

8. Contracts issued by a reporting entity that do not incorporate mortality or morbidity risk shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues but shall be recorded directly to an appropriate policy reserve account.

**Policy Reserves**

9. The reserving methodologies and assumptions used in computation of policy reserves shall meet the provisions of Appendices A-820 and A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

10. Policy reserves shall be established for all contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. Statutory policy reserves meet the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

11. The policy reserve for contracts without life contingencies where the future benefits are fixed and guaranteed (e.g., supplemental contracts, lottery payouts, structured settlements, guaranteed interest contracts, income settlement options, annuities certain, and unmatured coupon accumulations) shall be based on the present value of the future guaranteed benefits discounted at the valuation interest rate. The
policy reserve for all other contracts (e.g., premium and other deposit funds, and dividend and matured coupon accumulations) shall be based on the accumulated amounts paid plus an income accumulation based on the contract provisions, less any withdrawals and applicable surrender charges.

12. Policy reserves shall be increased for reinsurance assumed and decreased for reinsurance ceded as further described in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance.

Structured Settlements
13. Reporting entities that have accepted an assignment of obligations under structured settlements shall record those obligations consistent with the accounting and reporting provided for structured settlements in paragraphs 16 and 17 of Issue Paper No. 65 - Property and Casualty Contracts.

Cost Recognition
14. Interest credited to deposit-type contracts shall be recorded as an expense in the Summary of Operations when earned under the terms of the contract. Payments that represent a return of policyholder balances shall not be recorded as expenses. To the extent such payments differ from the recorded reserve, the difference shall be recorded in the Summary of Operations as a benefit expense.

Change In Valuation Basis
15. A change in valuation basis shall be defined as a change in the interest rate assumption or other factor affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the Summary of Operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a specific transition that allows for grading.

Unearned Income
16. Amounts assessed that represent compensation to the reporting entity for services to be provided in future periods and which are required to be refunded upon policy termination are not earned in the period assessed. Such amounts, if not already considered in the policy reserve, shall be reported as unearned income, a liability, and recognized as income as the related services are provided.

Additional Reserves Not Included Elsewhere
17. Additional actuarial liabilities are commonly held for such items as:
   a. Surrender values in excess of reserves otherwise required or carried
   b. Additional reserves required based on cash flow testing and/or asset/liability matching requirements.

Disclosures
18. For life and annuity reserves the financial statements shall disclose the following:
   a. A description of reserve practices including the amount of any surrender value promised in excess of the reserve as legally computed;
b. The method of determination of tabular interest on funds not involving life contingencies; and

c. The nature of significant other reserve changes.

19. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

a. Subject to discretionary withdrawal:

i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;

   (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the reporting entity; and

   (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in subparagraph v.(d) below;

iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;

iv. Total with adjustment or at market value;

v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

   (a) In a lump sum without adjustment;

   (b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

   (c) In a lump sum subject to a fixed surrender charge of less than 5%;

   (d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; and

   (e) All others.

b. Not subject to discretionary withdrawal;

c. Total gross;
d. Reinsurance ceded;
e. Total net.

DISCUSSION

SAP Considerations

20. The statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for deposit-type contracts are consistent with the Statement of Concepts which states:

Conservatism

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

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

Consistency

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

Recognition

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

21. Except as discussed in next two paragraphs, the statutory accounting principles outlined in the conclusion above regarding income recognition and policy reserves for deposit-type contracts are consistent with current statutory accounting.

22. Current SAP require amounts received on annuity and supplemental contracts without life contingencies and dividend and coupon accumulations to be recorded in the Summary of Operations as income. This issue paper changes current SAP to require that amounts received on deposit-type contracts be recorded directly to policy reserves and not recorded as income. This change was made to reflect that cash inflows (premiums) on deposit-type contracts do not result from providing insurance and are therefore not considered revenue. Similarly, payments to policyholders that represent a return of policyholder balances are not considered expenses. Revenues and expenses arise from the investment of amounts received from policyholders and interest credited to their accounts, respectively.
23. Consistent with Issue Paper No. 51, recording unearned income and other similar amounts as deferred income and recognizing the amounts as income only as the earnings process is completed is consistent with the objectives of the Statement of Concepts.

24. Significant differences exist between life and deposit-type contracts. Life contracts provide insurance protection against death while deposit-type contracts do not provide for mortality risk but act exclusively as investment vehicles. Unlike life contracts, deposit-type contracts frequently grant significant discretion over the amount and timing of payments by policyholders as well as the amounts that accrue to or that are assessed against policyholders by the reporting entity. As a result of these differences, the accounting requirements also vary. Premium income on life contracts is generally recognized on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract (e.g., single, renewal premiums, and any related premium adjustments) while income on deposit-type contracts is recorded based on the underlying performance of the invested assets. Due to these differences, the accounting for life and deposit-type contracts has been discussed in separate issue papers.

**GAAP Literature**

25. Consistent with Issue Papers Nos. 50 and 51, the GAAP literature, specifically FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises (FAS 60)*, FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97)*, and FASB Statement 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (FAS 120)*, for deposit-type contracts is rejected.

**Drafting Notes/Comments**

- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 53 addresses Property and Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)**

**Statutory Accounting**

26. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to policy reserves on deposit-type contracts:

**CHAPTER 10
AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS**

Annuity and Pure Endowment Contracts

Whereas life insurance provides protection from the loss arising from dying too soon, an annuity protects against the loss from living too long. An annuity can be in either an accumulative (premium paying or paid-up deferred) period or a payout period. The company's obligation in each period is different and is described in detail in the annuity contract.

Anticipated (and actual) mortality experience is different for persons purchasing annuity contracts than for persons who purchase life insurance. Mortality rates of annuitants are lower as a result of selection by the annuitants. For this reason, separate annuity mortality tables have been developed for the valuation of annuity contracts.
Pure endowments, also, are insurance contracts against living too long. A pure endowment benefit is exactly the opposite of term life insurance because the benefits are paid only if the insured survives the term of the contract. No benefit is paid if the insured dies before the end of the term. Sales of pure endowments are somewhat unusual—the typical endowment contract also includes some type of life insurance and, consequently, is valued as life insurance. Mortality tables for annuities also are used in reserving for pure endowment benefits.

Annuities and pure endowments can be sold either as individual contracts or as group contracts.

If there are interest rate guarantees on group annuity funds, additional reserves may be required by the statutes and regulations of the various states.

Reserves for group pension (group annuity) business involves more complex considerations, and a considerable degree of variation is permitted or prescribed by state regulations and statutes.

Miscellaneous Reserves

Since the actuarial liabilities must include provision for any contingent benefit or right which may arise, statutory statements provide for estimates of a number of miscellaneous reserve items. For example, state laws or regulations may require minimum reserves when valuation net premiums exceed gross premiums. The additional reserve needed to meet the minimum may appear separately as a miscellaneous reserve or may be included with the life reserve in accordance with the applicable state regulations. Similarly, provision for either nondeduction of deferred fractional premiums or return of premiums at death of the insured may be made as a separate reserve or as part of the life reserve. Approximate reserving methods are accepted and frequently used to estimate such items. Another minimum reserve which must be provided for is a reserve for surrender values in excess of reserves otherwise required or carried. There are other miscellaneous items commonly encountered, such as reserve for substandard extra premiums, a reserve for extra mortality on group conversions, and reserve for guaranteed insurability options.

Changes in Valuation Bases

Where the interest rate, mortality basis, reserving method (e.g., net level, preliminary term, etc.), or other basis affecting reserve computation of in force business is changed during the year, any increase or decrease in actuarial reserves resulting from this change in valuation basis must be charged directly to surplus rather than as a part of the reserve increase item in the summary of operations. For various reasons, any change in valuation bases which produces an increase in reserves (reserve strengthening) or decrease in reserves (reserve destrengthening) may require the approval of the applicable regulatory authority. Procedures and timing for such approval vary from state to state.

27. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to policy reserves on deposit-type contracts:

CHAPTER 12
DEPOSIT FUNDS AND OTHER LIABILITIES WITHOUT LIFE OR DISABILITY CONTINGENCIES

Liability for Premium and Other Deposit Funds

When a company receives premiums over one year prior to their due date, such premium deposits are usually recorded as a liability. A premium deposit fund is not considered to be discounted premiums; instead, interest at contracted rates is credited annually to each individual account. The terms of the fund (interest rate, disposition, and so forth) are specified in the policy or in a separate endorsement. A liability is established in the statutory financial statement for the balance of such premium deposits and accrued interest to the valuation date.
Guarantee investment contracts and other deposit funds of generally similar nature will give rise to statement liability. The terms of such contracts including provisions for early term or surrender of the contracts, must be considered in establishing the appropriate statement liability.

The statutory financial statement differentiates this category of deposit items in the following manner:

1. Premium deposit funds represent deposits made by policyholders to pay premiums in considerations at some future date. The deposits will not, however, be credited to premium or consideration income accounts until the premium due dates. The liability should include any interest declared and credited or accrued.

2. Guaranteed interest contracts (GICs) provide that the contractholder place one or more deposits with the insurance company in exchange for repayment of those deposits plus interest at a guaranteed rate(s). Both the deposits and the repayments are made according to a schedule provided in the contract. Other features common to GICs are:
   (a) The GIC contractholder is typically the sponsor or trustee of an employee benefit plan (pension, profit-sharing, thrift, savings, etc.)
   (b) The guaranteed interest rate on GICs is closely associated with new money rates at the time of contract issue. Lower guaranteed rates may apply to deposits made after the date of issue.
   (c) GICs often contain guarantees which limit insurance company administrative expense charges.
   (d) GICs are usually nonparticipating, that is, the contractholder does not share in good or bad investment experience of the insurance company. Some GICs base the guaranteed rate on an investment or economic index.
   (e) GICs normally contain penalties for failure of the contractholder to make scheduled deposits. In addition, penalties and/or restrictions on early or unscheduled withdrawals of funds are common.

The liability for GICs is subject to standard valuation law. Generally speaking, the minimum liability is equal to the future scheduled payments discounted back to the valuation date at the applicable valuation rate of interest. The minimum liability may exceed the amounts deposited accumulated at the guaranteed rates.

3. Other deposit items not otherwise included on Page 3.

Supplementary Contracts Without Life Contingencies

A supplementary contract is an agreement between the company and either the insured or the beneficiary, usually arrived at upon the termination of an original benefit contract, to provide for full or partial settlement of the amount payable under the original contract. However, such an agreement can be called a supplementary contract only when it is made for the payment of proceeds of a contract that has been written by the company. If the proceeds are to be paid over a definite period without regard to the life of the beneficiary, or are to be left at interest, the contract is termed a supplementary contract without life contingencies. (See Chapter 10).

Since supplementary contracts involve the payment of interest, the following terms become important. The “contract rate of interest” is the rate stated in the original policy or contract and is the minimum rate which may be paid on the amounts left under the option selected. If a company elects to establish a rate higher than the original contract rate as a minimum interest rate, this new rate becomes a “guaranteed rate.” In practice, some companies have established such guaranteed rates because of higher returns on investments than those anticipated when the original contracts were issued.
Reserves for supplementary contracts without life contingencies are reported as separate liability in the statutory financial statement. The reserve includes any interest credited or accrued to the statement date. For contracts being paid in installments, the reserve is the present value of the future payments.

28. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to premium income recognition on deposit-type contracts:

CHAPTER 18
PREMIUM INCOME

Premiums are generally recorded in the company's general ledger when received. This necessitates adjustments as of the balance sheet dates for premiums received in advance of their due date, for premiums which are due but have not yet been received, and for "deferred" premiums. Premium income reported in the Summary of Operations includes reinsurance assumed and is reduced by reinsurance ceded.

Deductions should be made for premiums and annuity considerations returned and allowances to industrial policyholders for direct payment of premiums. Commissions and allowances on reinsurance premiums assumed and ceded may not be deducted.

Single premiums and considerations include dividends, coupons, guaranteed annual pure endowments, and similar benefits applied to provide paid-up additional insurance or annuities. Renewal premiums collected are to include dividends and coupons applied to pay renewal premiums and to shorten the endowment or premium-paying period.

Cost of Collection in Excess of Loading

A liability should be provided for the cost of collection on premiums and annuity consideration deferred and uncollected in excess of total loading thereon if the company deems the loading to be inadequate. The increase in this item and the increase in loading on deferred and uncollected premiums are both recorded in the same line in the Summary of Operations. Provisions for cost of collection should include commissions, collection fees, and taxes contingent upon the collection of the deferred and uncollected premiums.

Premiums Received in Advance

Premium income reported in operations must exclude premiums that have been received by the company prior to the valuation date but which are due on or after the next policy anniversary date. The accounting treatment is the same for both life and accident and health premiums.

A policyholder may remit one or more premiums in advance of specific due dates. Where premiums are remitted sufficiently far in advance, the premiums may be discounted for interest from their due dates to the date of payment. The total amount of such gross premiums, less any discount as of the valuation date, is reported as a liability in the statutory financial statement. The gross premium less any discount is recorded as the advance premium, not the net valuation premium, in recognition of the company's liability to refund such premiums in the event the policy is terminated.

Advance premiums must be recorded for industrial as well as ordinary and group policies. Advance premiums received on group policies may be reported in the liability for premiums received in advance or as a 100% unearned premium reserve.

Premium and Other Deposit Funds

A company may also receive premiums over one year prior to their due date and include them in a premium deposit fund. These amounts are not reported as income. The premium deposit fund may or may not represent payment of specific future premiums. Interest at contracted rates is
credited annually to each individual account. Interest on such funds must be accrued to the balance sheet date. The terms of the fund (interest rate, disposition, and so forth) are specified in the provisions of the policy or in a separate endorsement. An explanation of other deposit funds can be found in Chapter 12.

Amounts deposited and accumulated for guaranteed interest contracts may be included in this classification. Finally, other deposit items of a generally similar nature may also be included herein.

Withdrawals from deposit accounts to pay premiums are credited to the appropriate income account. Provision is made in the statutory financial statement for reporting the balance of such deposits as of the balance sheet date.

Annuity Contracts

Certain annuity contracts, usually group pension contracts, frequently provide for the payment to the company of amounts other than premiums or considerations to be accumulated at interest for the purpose of providing pensions for employees at retirement and similar benefits. Amounts withdrawn from the fund to purchase annuity benefits reduce “Annuity and other fund deposits” and increase premium and annuity considerations.

Uncollected and deferred annuity considerations are calculated on deferred annuity contracts other than single payment contracts. The asset item is recorded net of loading.

Considerations for Supplementary Contracts

The Summary of Operations includes as income all policy proceeds which have been left with the company during the year under optional modes of settlement to provide beneficiaries or the policyowner with periodic income under a supplementary contract. Supplementary contracts may provide for an income payable for the lifetime of the payee(s), in which case the considerations would be reported as “Considerations for supplementary contracts with life contingencies.” A supplementary contract may also provide for the payment of a periodic income for a specified number of years or for payments of a specified amount until the funds with interest earnings are exhausted. The considerations for such supplementary contracts are reported separately as “Considerations for supplementary contracts without life contingencies.”

These considerations arise from proceeds retained at death, disability, surrender, or maturity of policies and annuity contracts. The amount of these retained proceeds is included in the amount reported in the Summary of Operations for policy and contract benefits.

Considerations for Dividend Accumulations

Another income item in the Summary of Operations is “Consideration for dividend accumulations.” The accounting treatment for dividend accumulation deposits, dividend accumulation payments, and the change in the liability is similar to accounting for life insurance. Consideration for dividend accumulations represents the amount of policy dividends left on deposit with the company during the year to accumulate at interest. This amount would normally agree with the amount reported in the Dividends and Coupons to Policyholders exhibit of the annual statement as being left on deposit with the company.

Generally Accepted Accounting Principles

29. FAS 97, as amended by FAS 120, provides the following guidance with respect to deposit-type contracts:

Summary

This Statement establishes standards of accounting for certain long-duration contracts issued by insurance enterprises, referred to in this Statement as universal life-type contracts, that were not
addressed by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. The Statement also establishes standards of accounting for limited-payment long-duration insurance contracts and investment contracts and amends Statement 60 to change the reporting of realized gains and losses on investments.

New life insurance contracts have evolved since the development of specialized insurance industry accounting principles and practices in the early 1970’s. Many of those new life insurance contracts have different provisions than do the life insurance contracts to which Statement 60 applies. Those new life insurance contracts are characterized by flexibility and discretion granted to one or both parties to the contract. Statement 60 identifies but does not address those contracts, noting that the accounting was under study by the insurance industry and the accounting and actuarial professions.

This Statement requires that the retrospective deposit method be used to account for universal life-type contracts. That accounting method establishes a liability for policy benefits at an amount determined by the account or contract balance that accrues to the benefit of the policyholder. Premium receipts are not reported as revenues when the retrospective deposit method is used. The Statement also requires that capitalized acquisition costs associated with universal life-type contracts be amortized based on a constant percentage of the present value of estimated gross profit amounts from the operation of a “book” of those contracts. Any gain or loss resulting from a policyholder’s replacement of other life insurance contracts with universal life-type contracts is recognized in income of the period in which the replacement occurs.

This Statement requires that long-duration contracts issued by insurance enterprises that do not subject the enterprise to risks arising from policyholder mortality or morbidity (investment contracts) be accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments. Payments received on those contracts are not reported as revenue.

This Statement also addresses limited-payment contracts that subject the insurance enterprise to mortality or morbidity risk over a period that extends beyond the period or periods in which premiums are collected and that have terms that are fixed and guaranteed. This Statement requires that revenue and income from limited-payment contracts be recognized over the period that benefits are provided rather than on collection of premiums.

**APPLICABILITY AND SCOPE**

6. This Statement applies to all insurance enterprises to which Statement 60 applies. The Statement establishes standards of financial accounting and reporting for three classes of long-duration contracts issued by those insurance enterprises and for reporting realized investment gains and losses. Those contracts are referred to in this Statement as investment contracts, limited-payment contracts, and universal life-type contracts. The accounting for long-duration contracts not otherwise addressed by this Statement is prescribed in Statement 60 and FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*.

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.
STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Universal Life-Type Contracts

17. The liability for policy benefits for universal life-type contracts shall be equal to the sum of:

   a. The balance that accrues to the benefit of policyholders at the date of the financial statements

   b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods (paragraph 20)

   c. Any amounts previously assessed against policyholders that are refundable on termination of the contract

   d. Any probable loss (premium deficiency) as described in paragraphs 35-37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

20. Amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts shall be reported as unearned revenue and recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, are unearned revenues.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 12, Deposit Funds and Other Liabilities Without Life or Disability Contingencies and Chapter 18, Premium Income
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 54 - Individual and Group Accident and Health Contracts
- Issue Paper No. 56 - Universal Life-Type Contracts, Policyholder Dividends, and Coupons
- Issue Paper No. 59 - Credit Life and Accident and Health Insurance Contracts
- Issue Paper No. 74 Life, Deposit-Type and Accident and Health Reinsurance
- Minutes of the Study Group on Accounting and Reporting Deposit-Type Business of the Accounting Practices and Procedures (EX4) Task Force from December 2, 1990 through March 6, 1994

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 53

Property Casualty Contracts - Premiums

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for premium recognition for property and casualty contracts, as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance Contracts In Force (Issue Paper No. 50), is contained in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices Procedures Manual). Under current statutory accounting, different methods are used for recording premiums. Regardless of the method used, premiums are generally recognized as earned in the statement of operations over the period of risk in proportion to the amount of insurance protection provided. Premiums for title insurance, mortgage guaranty insurance, financial guaranty insurance, retrospectively rated or other experience-rated contracts and single or fixed premium policies with coverage periods in excess of thirteen months are not included in the scope of this issue paper, but will be addressed in separate issue papers.

2. GAAP provides only general guidance on how to record premium, however GAAP requires an unearned premium reserve to be established and premium revenue to be recognized over the period of risk in proportion to the amount of insurance protection provided.

3. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue for property and casualty insurance contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in Issue Paper No. 50. It will establish the basic underlying accounting principles for premium revenue recognition of property and casualty insurance contracts and will be used as the basis to ensure consistency when establishing statutory accounting principles for revenue recognition.

5. Except as provided for in paragraph 6, written premiums shall be defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits and expenses associated with the coverage provided by the terms of the insurance contract. Frequently, insurance contracts are subject to audit by the insurer and the amount of premium charged is subject to adjustment based on the actual exposure. These premium adjustments are discussed in paragraph 10 of this paper.

6. For workers compensation contracts, which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.
7. Written premiums for all other contracts shall be recorded on the effective date of the contract. Upon recording written premium, a liability, the unearned premium reserve, shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).

8. The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of property and casualty contracts shall be recognized in the statement of operations, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 17. Certain issue papers provide for different methods of recognizing premium in the statement of operations for specific types of contracts. For contracts not separately identified in specific issue papers where the reporting entity can demonstrate the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

9. Additional premiums that are charged to policyholders for endorsements and for changes in coverage under the contract shall be recorded on the effective date of the endorsement and accounted for in a manner consistent with the methods discussed in paragraphs 7 and 8 so that at any point in time a liability is accrued for unearned premium equal to the premium amount charged for the unexpired portion of the policy endorsement.

10. Adjustments to the amount of premium charged for changes in the level of exposure to insurance risk (such as audit premiums on workers’ compensation policies) are generally determined based upon audits conducted after the policy has expired. Reporting entities shall estimate audit premiums, the amount generally referred to as earned but unbilled (EBUB) premium, and shall record such amounts as an adjustment to premium, either through written premium or as an adjustment to earned premium. Such amounts meet the definition of assets as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. Such amounts shall be adjusted upon completion of the audit and the adjustment shall be recognized as revenue immediately. The estimate for EBUB may be determined using actuarially or statistically supported aggregate calculations using company historical unearned premium data, or per policy calculations. Upon completion of an audit that results in a return of premiums to the policyholder, earned premiums shall be reduced. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be written off against operations in the period the determination is made. Reporting entities shall establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

11. When the anticipated losses, loss adjustment expenses commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each such grouping where a premium deficiency is indicated. Such deficiencies shall not be offset by anticipated profits in other policy groupings. If an reporting entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.
Disclosure Requirements

12. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;
b. Federal Employer Identification Number;
c. Whether such person holds an exclusive contract;
d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.); and
f. Total premium written.

DISCUSSION

13. This issue paper adopts current statutory guidance for all property and casualty contracts, except as outlined below. This issue paper modifies current statutory accounting to record the written premium based upon the effective date of the policy or endorsement, except for workers compensation premiums as discussed in paragraph 6 and premiums which are subject to adjustment, whereas current statutory accounting allows the recording of the premium when the daily report is processed, when the premium is due, or when the premium is paid. This issue paper therefore rejects the conclusions of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force reached in 1990 and reaffirmed on March 8, 1993, as it relates to premiums other than workers compensation, which allowed for certain written premiums to be recorded as billed. These changes were made to improve consistency in reporting. This is consistent with Issue Paper No. 6 - Amounts Due From Agents and Brokers and Issue Paper No. 10 - Uncollected Premium Balances. The pro-rata methods described in this issue paper provide for premium to be earned in proportion to the exposure to insurance risk for most property and casualty contracts as in most contracts the exposure to insurance risk does not vary significantly during the contract period. Property and casualty contracts where the exposure to insurance risk varies significantly during the contract period and it may not be appropriate to earn premium on a pro-rata basis are addressed in specific issue papers. For those few contracts not addressed in specific issue papers where the exposure to insurance risk varies significantly during the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. This paper also modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in paragraph 11. Current statutory guidance is silent regarding premium deficiency. This issue paper modifies current statutory guidance to allow EBUB to be recorded either through written premium or as an adjustment to earned premium. This change was made to provide consistency between the recording of this type of premium adjustment and retrospective premium adjustments.

14. The conclusions above reject FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60). The recognition of unearned premium as earned is consistent with GAAP except for those policies where the exposure to insurance risk differs materially during the contract period for which specific methods have been provided for the recognition of unearned premium as earned in certain issue papers. The recognition of a percentage of EBUB premium in excess of collateral as a nonadmitted asset is also not required by GAAP but is consistent with the conservatism and recognition concepts of statutory accounting.

15. The unearned premium reserve meets the definition of a liability as defined in Issue Paper No. 5. That issue paper defines liabilities as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or events. As stated in FAS 60 “premiums from short-duration insurance contracts, such as property and liability insurance contracts, are intended to cover expected claims costs resulting from insured events that occur during a fixed period of short-duration.” Therefore,
the unearned premium reserve represents the premium to be earned in the future intended to cover the unexpired portion of the policy which generally relates to the future sacrifice of economic benefit, which are the claim costs the reporting entity will pay if losses are incurred during the contract period.

16. Recording the premium as revenue in proportion to the period that insurance protection is provided is consistent with the Recognition concept in the Statement of Concepts. The Recognition concept states, “revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.” Therefore, as the period that is protected expires, the underlying earnings process is completed and the revenue should be recognized.

Drafting Notes/Comments
- Accounting for specific types of property and casualty insurance contracts will be addressed in separate issue papers.
- Accounting for reinsurance will be addressed in Issue Paper No. 74 - Life and Accident and Health Reinsurance and Issue Paper No. 75 - Property and Casualty Reinsurance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
17. Chapter 14, Premiums, in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to premiums:

Different methods of recording written premiums are used and generally follow the company’s plan of operation. For example, premiums may be recorded when the daily report is processed, when the premium is due, or when the premium is paid. Many companies use combinations of these methods. Whatever recording method is used, premiums written include the following categories: direct premiums, assumed reinsurance premiums and ceded reinsurance premiums.

Direct Premiums

The major portion of most companies’ premiums written is direct premiums. Direct premiums include all premiums arising from policies issued by the company acting as the primary insurance carrier. These premiums should be adjusted for any return or additional premiums arising from endorsements, cancellations, audits, and retrospective rating plans.

Direct written premiums are generally recorded for the full policy term. See Chapter 7-Agents’ Balances or Uncollected Premiums, for recording of uncollected premiums.

Endorsement entries generally follow the same recording path as the original entries. Those policies subject to audit may be adjusted on a monthly, quarterly, semi-annual, or annual basis with the premium resulting from a physical review of the exposure immediately recorded as written. Adjustments resulting from retrospective rating plans are immediately recorded as written premiums.

Assumed and Ceded Reinsurance Premiums

Assumed reinsurance premiums include all premiums (less return premiums) from contracts issued to reinsure another insurance company. Ceded reinsurance premiums include all premiums (less return premiums) transferred to another insurance company for reinsurance purchased.

Net Written Premiums

The net written premiums of an insurance company are equal to the direct premiums, plus the reinsurance assumed premiums, less the reinsurance ceded premiums. Net written premiums are shown in the Underwriting and Investment Exhibit of the annual statement.
**Earned Premiums**

The earned premiums of an insurance company represent the pro rata portion of the premiums in force applicable to the expired portion of the policy term, plus or minus the premiums earned on audits and other adjustments. To compute earned premiums, deduct from net premium writings the net change which has taken place during the period in total unearned premium reserve.

The Underwriting and Investment Exhibit of the annual statements shows the components of earned premiums during the year for each line of business. The total earned premiums are reported in the Statement of Income of the annual statement.

**Earned But Unbilled Premiums**

Earned but unbilled premiums (EBUB) typically arise out of the issuance of workers’ compensation policies. Since workers’ compensation premiums are usually based on payroll statistics, premium billings to the employer are generally estimated and are subject to insurer audit, at which time the true final premium is calculated. If the actual payroll exceeds the payroll figure used in the calculation of premium billings, an additional premium may be owed the insurer. If the actual payroll is less than that used in the premium billing calculation, a return premium may be owed the employer.

An insurer may recognize as an asset accrued EBUB. Actuarially or statistically supported aggregate calculations, using company historical unearned premium data, or per policy calculations are acceptable methods of establishing this asset. To the extent an insurer chooses to recognize the asset for EBUB, it must establish all of the requisite liabilities associated with the asset such as commissions and premium taxes.

EBUB should be reported in the annual statement as written premium and premium receivable. It should not be netted against unearned premiums. Ten percent of EBUB in excess of collateral specifically held and identifiable on a per policy basis must be reported in the annual statement as a non-admitted asset.

18. Chapter 12, Unearned Premiums, in the P&C Accounting Practices and Procedures Manual contains the following guidance pertaining to unearned premiums:

At the expiration of an insurance contract or policy, the entire premium has been earned. Any point prior to expiration, the company is required to establish a pro rata portion of the premium as a liability to cover the remaining policy term. The company’s total unearned premium reserve represents the unearned premium liability for all policies in force.

A number of methods are used for the computation of the unearned premium reserve. In one method, the unearned premiums are calculated by applying the appropriate factors or fractions to the original premiums in force, segregated by line of business, term, and date of expiration. The premium for the full original term is used for this purpose because the factors or fractions are calculated on the basis. When a policy is canceled, the full original premium should be deducted from the total premium in force; otherwise, premiums in force and unearned premiums would be overstated. During the life of a policy, changes are frequently made, resulting in additional or return premiums. For example, a one-year policy may have its premium increased or decreased by a change in coverage after it has been in force for six months, in which case the insured might pay additional premium or receive a return premium. Theoretically, the full annual premium for changes should be calculated so that premiums in force for the one-year term may be correspondingly increased or decreased. However, as a practical matter, some companies adjust the premiums in force by the amount of the actual additional premium or return premium, other than in the event of cancellation, on the assumption that the resulting errors in the premiums in force will largely offset one another.
One of the more common assumptions used by companies to calculate an unearned premium reserve is the monthly pro rata method. This method assumes that, on the average, the same amount of business is written each day of any month so that the mean will be the middle of the month. For example, one-year premiums written during the first three months of the year have, at the end of the year, the following unearned fractions: January-1/24; February-3/24; March-5/24.

A second method is to calculate the unearned premium on each policy. At the end of each period, the calculation is made on each item of premium to ascertain the unexpired portion and to arrive at the aggregate unearned premium reserve.

If a company assumes reinsurance, it must provide the same unearned premium reserve that would have been provided by the ceding company if reinsurance had not been placed.

There are a number of methods used to calculate unearned premium reserve. Certain states have a provision in their statutes which prescribes the method or methods which should be used.

**Audited Policies**

Audited premiums are earned as soon as they are recorded, whether they are interim audits or final audits. Many audited policies are written with a deposit premium and provide for monthly, quarterly, or semi-annual audits in addition to the final audit after expiration. Deposit premiums should be earned in such a manner that in conjunction with interim and final audits, earned premium will be correctly reflected during the policy term.

19. Pertinent excerpts of the December 3, 1990 meeting minutes of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) are as follows:

At its September 10, 1990 meeting (EI 90-3) the working group then adopted the following accounting manual language subject to the development of suitable disclosures and interrogatories:

Written premiums may be recorded at the processing point where the premium amount and term are determinable, e.g., when the daily report is processed, when the premium is billed, or when the premium is collected.

Contracts which have both a fixed policy period and a fixed premium are recorded at the inception date for the term of the policy. This approach should be used in cases where policies have a fixed premium but offer policyholders the option to pay monthly, quarterly, or on some other modal basis, and in cases where the premium has been financed with the insurer receiving the full premium.

For contracts which have a premium based upon changes in the activities of the insured, written premiums may be recorded on an installment basis to match the billing to the policyholder. Under this type of arrangement, the premium is determined and billed according to the frequency stated in the contract and written premium is recorded on the basis of that frequency.

**Generally Accepted Accounting Principles**

20. FAS 60 contains the following guidance pertaining to revenue recognition for short-duration contracts:

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.
9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

21. Paragraph 33 of FAS 60 provides the following guidance on accounting for premium deficiencies on short-duration contracts:

A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.6

 Disclosure is required regarding whether the insurance enterprise considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists (paragraph 60(e)).

22. The AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies contains the following regarding revenue recognition under GAAP:

Revenue Recognition

3.32. Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.

3.33. As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting-form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the
period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 12 and 14
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 6 - Amounts Due From Agents and Brokers
- Issue Paper No. 10 - Uncollected Premium Balances
- Issue Paper No. 50 - Classifications and Definitions of Insurance Contracts In Force
- Minutes of the December 3, 1990 meeting of the Emerging Accounting Issues Working Group

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- AICPA Audit and Accounting Guide: Audits of Property and Liability Insurance Companies, Section 3.32, Revenue Recognition

State Regulations
- No further guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 54

Individual and Group Accident and Health Contracts

STATUS
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Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on income recognition and policy reserves for individual and group accident and health contracts, as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50), is addressed in Chapter 13, Aggregate Reserves for Accident and Health Policies and Chapter 18, Premium Income, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance addresses income recognition and policy reserves related to individual and group accident and health contracts. Under current statutory accounting, premiums are recorded on a gross basis when due from policyholders and policy and claim reserves are computed based upon specific contract provisions and the methods described in the NAIC Model Law, Minimum Reserve Standards for Individual and Group Health Insurance Contracts (Individual and Group Health Model Law), the Long-Term Care Insurance Model Regulation, and the Actuarial Standards of Practice promulgated by the American Academy of Actuaries. Further, policy and claim reserves must, in the aggregate, place a sound value on both present and future liabilities.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts are those contracts expected to remain in force for an extended period and include certain noncancelable and guaranteed renewable accident and health contracts. All other insurance contracts are considered short-duration contracts and include most property and liability insurance contracts. Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the reporting entity, are recognized when insured events occur. GAAP guidance requires policy reserves for individual and group accident and health classified as long-duration to be established using actuarial assumptions applicable at the time the insurance contracts are made, or for short-duration contracts, using an unearned premium reserve.

3. The purpose of this issue paper is to establish statutory accounting principles for policy and claim reserves for all individual and group accident and health contracts consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Credit accident and health insurance contracts are discussed in Issue Paper No. 59 - Credit Life and Accident and Health Insurance Contracts.

SUMMARY CONCLUSION

Income Recognition

4. Premiums shall be recognized as income on the gross basis (amount charged to the policyholder or subscriber exclusive of copayments or other charges related to the receipt of healthcare services) when due from policyholders or subscribers, but no earlier than the effective date of coverage under the terms of the contract. Due and uncollected premiums shall follow the guidance in Issue Paper No. 10 - Uncollected Premium Balances (Issue Paper No. 10), to determine the admissibility of premiums and...
related receivables. Premiums waived by the reporting entity under disability provisions contained in its policies and contracts, and reported in operations as a disability benefit, are included in premium income.

5. Premium income shall exclude premiums that have been received by the reporting entity on or prior to the valuation date but which are due after the valuation date (i.e., advance premiums as discussed below).

6. Premium income shall be reduced for premiums returned and allowances to industrial policyholders for the direct payment of premiums.

7. Premium income shall be increased by reinsurance premiums assumed and reduced by reinsurance premiums ceded. Reinsurance premiums assumed and ceded shall be defined and addressed in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance.

8. Advance premiums are those premiums that have been received by the reporting entity prior to or on the valuation date but which are due after the valuation date. The total amount of such advance premiums is reported as a liability in the statutory financial statement and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the company's liability to refund such premiums in the event the policy is terminated.

9. As discussed in Issue Paper No. 47 - Uninsured Plans, amounts received on behalf of uninsured plans or the uninsured portion of partially insured plans shall not be reported as premium income. Administrative fees for servicing the uninsured plans shall be deducted from general insurance expenses. Conversely, income relating to the insured portion of any plan shall be reported as premium income.

**Reserve Requirements**

10. The aggregate reserve for individual and group accident and health contracts generally consists of a policy reserve and a claim reserve as well as certain other miscellaneous reserves discussed in paragraphs 26 and 27. The aggregate reserve reflects the future liabilities arising under accident and health insurance policies. Policy reserves have traditionally been referred to as active life reserves and include unearned premium reserves. Policy reserves reflect that premiums cover future liabilities in addition to current claim costs and expenses. Claim reserves, sometimes referred to as disabled life reserves, are required on claims which involve continuing loss. The reserve in this case is a measure of the present value of future benefits or amounts not yet due as of the statement date (the unaccrued portion) which are expected to arise under claims which have been incurred as of the statement date. The aggregate reserve for individual and group accident and health contracts does not include claim liabilities which are the amounts payable at the reporting date (the accrued portion) and reflect the reporting entity’s liability for benefits due as of the statement date. Claim liabilities are further discussed in Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses.

11. Policy reserves for individual and group accident and health contracts shall include an unearned premium reserve and, as applicable, an additional or contract reserve where constant or level premiums are assumed for certain noncancelable or guaranteed renewable contracts. The claim reserve shall consist of a reserve for the present value of amounts not yet due.

12. Statutory policy reserves shall be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. A prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Statutory reserves meet the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.
13. The reserving methodologies and assumptions used in calculating individual and group accident and health reserves shall meet the provisions of Appendices A-010, A-641, A-820 and A-822 and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

**Policy Reserves**

14. Unearned premium reserves shall be required for all accident and health contracts for which premiums have been reported for a period beyond the date of valuation other than premiums paid in advance. The minimum unearned premium reserve that applies to the premium period beyond the valuation date shall be based on the valuation net modal premium if contract reserves are required and the gross modal unearned premium reserve if contract reserves are not required. If premiums due and unpaid are carried as an asset, such premiums must be treated as premiums in force, subject to unearned premium reserve determination. The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums must be carried as an offsetting liability. In no event, however, shall the aggregate policy reserve for all contracts be less than the unearned gross premium under such contracts. Additionally, the reserve shall never be less than the expected claims for the period beyond the valuation date represented by the unearned premium reserve, to the extent not provided for elsewhere.

15. Contract or additional reserves on accident and health contracts shall be recorded when premiums and benefits are not earned or incurred at the same incidence over the policy period (e.g., contracts having premiums determined on an issue-age basis where premiums and related morbidity, risk of loss, and the cost of coverage are not evenly matched). This evaluation may be applied on a rating block basis if the total premiums for the block were developed to support the total risk assumed and expected expenses for the block each year, and a qualified actuary certifies the premium development (e.g., community-rated contracts). The additional reserves shall be set aside from the early years’ level premiums to pay the claims that experience indicates will be incurred as the policy continues in force. The fact that the reporting entity may have the right to increase premiums or to decline renewal of the policies for certain reasons has no bearing on whether or not a contract or additional reserve should be held. These reserves shall apply to regardless of whether or not benefits are currently being received, and are in addition to unearned premium reserves discussed in paragraph 14.

16. Contract or additional reserves shall also be recorded where, due to the gross premium structure, the future benefits exceed the future net premiums (e.g., group conversion policies) or where the contract provides for the extension of benefits after the termination of the coverage (e.g., deferred maternity and other similar benefits).

17. A terminal reserve for accident and health contracts is the policy reserve at the end of a policy year to cover the assumed difference between future benefits and future net premiums. The components used to compute a terminal reserve shall consist of an interest rate, a mortality and/or morbidity table, and a valuation method (e.g., net level, one-year full preliminary term, and two-year full preliminary term) and where allowed, other assumptions. A terminal reserve is based on the assumption that all net premiums have been received, all interest earned, and all benefits paid to the end of the policy year.

18. Since terminal reserves are computed as of the end of a policy year and not the reporting date, the terminal reserve as of policy anniversaries immediately prior to and subsequent to the reporting date are adjusted to reflect that portion of the net premium that is unearned at the reporting date. This is generally accomplished using either the mean reserve method or the mid-terminal method as described in paragraph 22 of Issue Paper No. 51 - Life Contracts (Issue Paper No. 51). Other appropriate methods, including an exact reserve valuation, may also be used.

19. For individual accident and health contracts, negative reserves on any benefit shall be offset against positive reserves for other benefits in the same policy but the mean reserve on any policy shall
never be taken as less than one-half the valuation net premium. The majority of group accident and health policies are written in conjunction with group life or other policies. If these policies are an experience rated package, positive or favorable margins on one of the contracts can offset the need to establish additional reserves on the other contracts.

Additional Reserves
20. When the expected claims payments or incurred costs, claim adjustment expenses and administration costs exceed the premiums to be collected for the remainder of a contract period, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency, with a corresponding charge to operations. For purposes of determining if a premium deficiency exists, contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings. Such accruals shall be made for any loss contracts, even if the contract period has not yet started.

Claim Reserves
21. Claim reserves shall be accrued for estimated cost of future health care services to be rendered that the reporting entity is currently obligated to provide as a result of premiums earned to date and that would be payable after the reporting date under the terms of arrangements, regulatory requirements or other requirements if the insured’s or subscriber’s illness or disability were to continue. It shall include a reserve for disability benefits covered under premium waiver provisions. For individual and group disability claims with a duration of less than two years, reserves may be based on the reporting entity’s experience, if credible, or other methods, as appropriate. Generally, reserves for disability income claims with durations of greater than two years shall be determined based on a tabular method using the age of the insured at the date of disablement, the number of months the insured already has been disabled, and the number of months remaining in the benefit period.

Reserve Recognition
22. The difference between the aggregate reserve for accident and health contracts at the beginning and end of the reporting period shall be reflected in the summary of operations, except for any difference due to a change in valuation basis.

Change In Valuation Basis
23. A change in valuation basis shall be defined as a change in the interest rate, mortality or morbidity assumption, or reserving method (e.g., net level, preliminary term, etc.) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3). Consistent with Issue Paper No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

Supplemental Benefits
24. In addition to the basic policy benefit, the contract may provide supplemental benefits. Supplemental benefits include, but are not limited to, accidental death benefits, dental and waiver of premium benefits. If the terms of the contract provide for these benefits, appropriate reserves shall be established in accordance with the applicable standards within this Codification.

Reserve Adequacy
25. As discussed in Appendix A-010, a prospective gross premium valuation is the ultimate test of the adequacy of a reporting entity’s accident and health reserves as of a given valuation date and shall be
determined on the basis of unearned premium reserves, contract or additional reserves, claim reserves (including claim liabilities), and miscellaneous reserves combined; however, each component shall be computed separately.

**Additional Reserves Not Included Elsewhere**

26. Reserve for experience-rating refunds or the dividend liability in group policies are discussed in Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts.

27. Additional actuarial or other liabilities are commonly held for such items as:
   a. Surrender values in excess of reserves otherwise required or carried;
   b. Additional reserves required based on cash flow testing and/or asset/liability matching requirements; and
   c. Additional reserves for policies which contain conversion privileges or future contingent benefits.

**Contracts Subject to Redetermination**

28. This statement also applies to other contracts which are subject to redetermination such as Federal (and State) Groups – subject to rate adjustments through audits by the Office of Personnel Management (“OPM”). Reporting entities are required to give Federal Groups the lowest rates that are being charged to similar groups.

29. Amounts due from insureds or subscribers and amounts due to insureds or subscribers under contracts subject to redetermination meet the definitions of assets and liabilities as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and Issue Paper No. 5, respectively.

30. Contract redeterminations shall be estimated based on the experience to date. The method used to estimate the liability shall be reasonable based on the reporting entity’s procedures, and consistent among reporting periods. An examination of contract requirements in relation to the rates being charged and the current status of applicable audits (e.g., OPM, Health Care Finance Administration and other Federal, state or government department) is a common method used to estimate such contract redeterminations.

31. Premium adjustments for contracts subject to redetermination are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Accrued premium adjustments shall be recorded as a write-in for other than invested assets, with a corresponding entry to premiums; accrued return premium adjustments shall be recorded as a liability with a corresponding entry to premiums.

32. If, in accordance with Issue Paper No. 5, it is probable that the additional premium adjustment is uncollectible, any uncollectible premium shall be written off against operations in the period the determination is made and the disclosure requirements outlined in Issue Paper No. 5 shall be made.

33. Premium adjustments for contracts subject to redetermination shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If such premiums are not billed in accordance with the policy provisions or contract provisions, or the policy provisions or contract provisions do not address the due date of such premiums, the accrual shall be nonadmitted. This is consistent with the guidance for audit premiums established in Issue Paper No. 10.

**Disclosures**

34. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in
Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;
b. Federal Employer Identification Number;
c. Whether such person holds an exclusive contract;
d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.);
f. Total premium written.

35. If a premium deficiency reserve is established in accordance with paragraph 20, disclose the amount of that reserve.

DISCUSSION

36. This issue paper adopts the current statutory accounting guidance for premiums, policy reserves, and claim reserves associated with accident and health contracts. However, paragraph 20 of this issue paper expands the current requirements for reserving for contracts where due to the gross premium structure, future benefits exceed future premiums.

37. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism, consistency and recognition concepts in the Statement of Concepts which state:

Conservatism

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

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

Consistency

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

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

Claim Reserves - Indemnity and Managed Care Contracts
38. As discussed in paragraph 21, claim reserves shall be accrued for estimated amounts that would be payable after the reporting date if the insured’s illness or disability were to continue. For health maintenance organizations claims reserves shall be provided if the benefits for the event extend beyond the contract period. For claims with a duration of less than two years, there are a variety of acceptable methods for calculation. Some of them are: (a) use of the disabled life table -- either a published table or one based on the insurer’s experience; (b) use of an estimate made by the insurer’s claim department for each policy (the individual judgment approach); or (c) other appropriate estimation techniques.

39. The method used to compute the claim reserve must be appropriate in the circumstances. Historical development might provide information as to the appropriateness of the method used by developing statistics to show that its method would (or actually did) produce adequate reserves for prior valuation periods. If the loss-of-time policy provides a waiver of premium benefit, the reserve for policies that are having their premiums waived should be included with the disabled life reserves.

Level Premiums - Indemnity Contracts
40. As discussed in paragraph 15 of this issue paper, contract or additional reserves on accident and health contracts shall be recorded when premiums and benefits are not earned or incurred at the same incidence over the policy period. The Life/A&H Accounting Practices and Procedures Manual requires contract reserves on individual accident and health policies but does not specifically extend this requirement to group policies. This issue paper clarifies current SAP to require contract reserves on group accident and health policies, including those group accident and health contracts that are individually underwritten.

Future Contingent Benefits - Indemnity Contracts
41. A reporting entity shall establish a reserve for future contingent benefits which extend beyond the termination of the policy, subject to specific contract provisions. Such provisions which accrue and are payable at some future date, are predicated on a condition or actual disability which existed at the termination of the contract and which is usually not known to the reporting entity at the time of the termination (e.g., deferred maternity benefits). In situations where the actual disability is not known to the reporting entity at the time of the termination, the reserve shall be computed based on relevant pricing, periodic, or industry studies of similar benefits on terminated policies. Reporting entities shall separately compute a reserve for deferred maternity benefits and any other extended benefits under group contracts.

Extension of Benefits - Indemnity Contracts
42. An additional reserve shall be required for group accident and health contracts which contain a conversion privilege. The minimum additional reserve shall equal the excess morbidity costs assumed in the premium payable on the terminated coverages. If future guaranteed rates are inadequate to meet future obligations, then additional reserves shall be established. A reserve shall be established to cover the expected benefit payments for any policy having a conversion privilege or other similar extension of benefits when the policy is terminated with no additional premiums due but the benefits extend beyond the termination date. However, for cases where the experience of the case or the experience of a block of cases is reflected back to the policyholder, the dividend liability or provision for experience rating refunds is a direct offset to the need to establish an additional reserve.
GAAP Literature
43. Consistent with Issue Papers Nos. 50 and 51, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60), relating to individual and group accident and health contracts is rejected for the reasons set forth in those issue papers. However, some of the elements regarding income recognition have been used in this issue paper.

Drafting Notes/Comments
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 59 addresses Credit Life and Accident and Health Insurance Contracts.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting
44. Chapter 13, Aggregate Reserves For Accident and Health Policies, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health reserves:

Accident and health insurance provides protection against economic losses resulting from accident and/or sickness. This insurance may be provided under individual policies, under group or franchise policies, or it may be provided under certain special types of policies which bear unique titles such as credit insurance. The economic losses which accident and health insurance policies cover, or the types of benefits provided, will vary with different policies. For example, reimbursement for hospital, surgical, or medical expenses may be provided under a hospital expense policy, while under other policies, a more comprehensive form of coverage, known as major medical insurance, may be offered. Similarly, policies may provide monthly benefits for loss of income from disability, either on a short term or a long term basis, or only for disabilities due to accident. Loss of life from accident may be covered under accidental death policies, while under certain limited accident policies, only accidental death from air travel may be covered. Therefore, accident and health policies may be categorized by the form of policy through which the coverage is provided; it may be categorized according to the benefits provided by the policy; or it may be categorized by the contingencies insured against. These variations in types of policies and the benefits provided must be considered in discussing the reserves for accident and health insurance policies.

Accident and health policies are offered by life companies, casualty companies, fraternal benefits societies, and certain specialty companies. While the coverage originated with casualty companies, it is now the life insurance companies which provide the majority of accident and health insurance. The history of the business is important because many of the concepts currently used originated from casualty insurance practices and use casualty terminology. Since the life insurance companies began writing this insurance, the form of the policies and the concept of coverages have changed, which also produced changes in reserving practices.

At one time, all reporting of accident and health insurance was on the miscellaneous blank, which was originally designed for the casualty companies. The policies then offered were referred to as commercial policies under which the insurer had the right to cancel or fail to renew coverage. Some noncancellable accident and health insurance was written with specific reserve requirements for those policies. The premium rates for commercial policies were often on a uniform rate basis, with the same premium applying to a broad range of ages. Under the casualty concept, the reserves for these commercial policies consisted primarily of an unearned premium
reserve and claim reserve. The unearned premium reserve was intended to recognize that portion of a premium which covered a policy period extending beyond the valuation date. Claim reserves were required to recognize the liability of the company for claims which had not been paid or were being processed. The titles assigned to the various claim reserves were intended to reflect their payment status; however, over the years, procedures have changed and certain of the reserves are calculated differently but still bear the same titles. Reserves in the statutory financial statement required for accident and health insurance are measures of the value of liability for future obligations of an insurer. Two basic types of reserves are required to value the future liabilities arising under accident and health insurance policies. “Policy reserves” have traditionally been referred to as active life reserves and unearned premium reserves and are a recognition that premiums cover future liabilities in addition to current claim costs and expenses. “Claim reserves,” sometimes referred to as disabled life reserves, are required on claims which involve continuing loss. The reserve in this case is a measure of the present value of future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. “Claim liabilities,” to be discussed in a later chapter, are a measure of an insurer’s liability for benefits due as of the statement date.

In many respects, the reporting of accident and health insurance is similar to that used for life insurance but the reserving of accident and health insurance differs significantly from that used for life insurance. The separation of the claim reserve is an example of unique accident and health reserving and will be discussed later. This chapter will analyze accident and health reserves from a general standpoint and reference will be made to the numerous regulations on accident and health reserves which have been recommended by the NAIC and which have been promulgated at various times by the different states. It is not intended that those reserve recommendations be restated in this chapter but comments will be made to enhance their understanding.

**Individual Accident and Health Policies**

Individual accident and health policies, other than credit insurance, are separated for reserve reporting purposes in the statutory financial statement into six classifications. The definitions are included in the instructions for the statutory financial statement and are based principally on the renewal agreement of the policy. There is some variation in the reserve requirements which apply to the different renewal classifications of policies but most reserve requirements apply to all individual policies.

**Legal Requirements for Reserves**

For life insurance, the standard valuation law defines the minimum standard which a company’s aggregate reserves must meet. However, for accident and health insurance, the statutes of most states provide that the insurer shall maintain an active life reserve which shall place a sound value on its liabilities under its accident and health policies and be not less than the reserve according to the appropriate standards set forth in regulations issued by the insurance department. In other states which have not adopted specific reserve requirements for accident and health insurance, the requirement for reserves may be based on more general statutory requirements or on the instructions to the statutory financial statement. Those instructions provide that a reserve must be carried for any policy which provides guarantee of renewability, and the standards adopted by the NAIC in December 1964, are indicated to be an acceptable basis for such additional reserves. The report of the Industry Advisory Committee on Reserves for Individual Accident and Health Policies, approved by the NAIC in December 1964 has served as the basis for the reserve regulations promulgated by many insurance departments. Revisions in the regulations may change the reserve requirements, as well as provide for new morbidity tables, without a change in the reserve law of a state as is true for life insurance.

**Unearned Premium Reserves**

These reserves are established for all accident and health policies and are equivalent to the amount of the gross premium for that portion of the premium period which extends beyond the
valuation date. The unearned portion may be computed on a pro rata basis using the actual due dates, or it may be computed on the “monthly pro rata method,” which assumes that all premiums are collected evenly throughout the month. Special consideration should be given to the method used if there is a high concentration of premiums due on a given date because of company practices in the dating of policies. Care must be taken to insure consistency between unearned premium reserves and premiums reported as due and unpaid. For example, if a company is taking a due and unpaid premium for a policy as an asset, the appropriate portion of that premium should be included in the unearned premiums just as if the premium had actually been paid.

Active Life or Additional Reserves

These reserves arise as a consequence of the rating concept for the policy where a constant or “level premium” is assumed over a specified period of years during which the cost of insurance increases with the increasing age of the insured lives. This is similar in concept to the reserves provided for term life insurance policies, but again, there are distinct differences. The active life reserve is required of all in-force policies, which would include policies on those lives which are currently disabled and receiving benefits, and is in addition to any reserves required on those lives in connection with the claim. Active life reserves are necessary because the level premiums, as with life insurance, will likely prove to be inadequate to meet future claim costs as the policies mature. The additional reserves are, therefore, set aside from the early years’ level premiums to pay the claims that experience indicates will be incurred as the policy continues in force. The fact that the insurer may have the right to increase premiums or to decline renewal of the policies for certain reasons has no bearing on the calculation of the active life reserves. These additional reserves are not required of policies with certain renewal agreements.

Specific morbidity tables, valuation methods and interest rates have been included in the NAIC recommendations as minimum standards. The policy reserves established and maintained by a company should place a sound value on both present and future liabilities under those policies and should not be less than the minimum values determined by the methods and bases described therein.

The morbidity tables specified in the NAIC recommendations should be viewed as minimum standards. While these morbidity tables have been developed from industry experience data, it has not been possible to recognize all the variations in policy benefits or underwriting philosophies of all companies. Appropriate modifications should be made to reflect the actual benefits provided in the policy. Similarly, recommended morbidity tables do not exist for certain benefits so there is a need to develop reserves based on the insurer’s recent morbidity experience, or on recognized published morbidity experience, such that a sound value is placed on the liabilities under that benefit.

The NAIC recommendations permit alternative valuation procedures and assumptions. Often the great variety of benefits and options in accident and health policies make it impractical to precisely value each variation. Approximations such as those involving age groupings, groupings of several years of issue, or average amounts of indemnities are among those mentioned. Others include the computations of the reserve for a policy benefit as a percentage of some other policy benefit or the use of composite annual claim costs for all or any combination of the benefits included in the policies.

The insurer may employ the use of either the level premium, the one-year preliminary term, or the two-year preliminary term valuation methods. The reserves may be shown as mean reserves diminished by appropriate credit for valuation net deferred premiums or as mid-terminal reserves plus the gross or net unearned premium reserves. In no event, however, may the aggregate reserve for all policies be less than the unearned gross premium under such policies. For statement purposes, the net reserve liability may be shown as the excess of the mean reserve over the amount of net unpaid and deferred premiums or, regardless of the underlying method of calculation, it may be divided between the unearned gross premium reserve and a balancing item for the “additional reserve” which is generally based on the mid-terminal reserves. The insurer is
required to attach to the statutory financial statement a description of the valuation standards
used in calculating the reserves, and to specify the reserve basis, interest rates, and methods.

Because of the aggregate and average nature of policy reserves, deficiency reserves are
normally not required for accident and health insurance. Negative reserves on any benefit may
be offset against positive reserves for other benefits in the same policy but the mean reserve on
any policy should never be taken as less than one-half the valuation net premium.

Reserves for cash value, return of premium, or other nonforfeiture benefits should be calculated
using interest, mortality, and morbidity, provided the value of benefits payable upon death is
included in the calculation; otherwise, reserves should be calculated on a sinking fund basis
using interest and morbidity only. The aggregate policy reserves established for these, over and
above any policy reserve required for other policy benefits, should not be less than the aggregate
of any withdrawal benefits then payable. Where cash value or return of premium benefits are
payable periodically, reserves should be calculated on a recurring term period basis, consistent
with the payment cycle.

**Group Policies**

All organizations that qualify to purchase group life insurance may also, by most state laws,
purchase accident and health insurance. In many states, the definition of what constitutes an
eligible group for accident and health insurance is entirely left up to any set of good underwriting
practices established by the insurance company.

Some insurers may act as administrators of accident and health plans under which the plans
bear the risk of claims. Such plans are commonly termed “administrative services only” plans and
are described in this manual as “uninsured plans.” For additional discussion see Chapter 8—Other Admitted Assets.

The insurer’s aggregate reserves should not include any amounts arising from uninsured
accident and health plans or the uninsured portion of partially insured plans. The insured portion
of any partially insured plan should be treated as any other insured plan with appropriate
reserves established.

**Legal Requirements for Reserves**

The minimum reserve for active lives is the gross unearned premium. Unlike life insurance,
where due and outstanding premium is a net valuation premium and reserves are also net
valuation premium reserves, group accident and health due and outstanding premium and
unearned premium reserves are reported on a gross basis. There is, therefore, no need to
calculate loading or establish the excess of the cost of collection over loading for group accident
and health policies. The liabilities established on due and outstanding premiums are discussed
elsewhere in this manual.

**Unearned Premium Reserves**

The methods of computing group unearned premium reserves may vary between companies and
even within a company, depending upon the premium due dates of the policies involved. The
monthly pro rata gross unearned premium is a common method used. The assumption of uniform
issuance is applied in the monthly pro rata method. At the end of the month in which the premium
is due, one-half of the premium is considered to be earned and one-half is considered to be
unearned.

Unearned premium reserves also may be based on the actual due date of the premium; this has
been referred to as the “daily pro rata” method. It is the most precise basis. Sometimes a
combination of the two methods is used. An unearned premium reserve of zero is established for
all policies with monthly premium due dates of the first day of the month. For all other monthly
policies, a uniform distribution is assumed. Most group accident and health policies are billed on
a monthly basis but, in a few cases, quarterly, semiannual, and even triannual modes are encountered. Premium modes other than monthly can be handled in similar fashion.

Additional Reserves

Some states may require an additional reserve for policies which contain a conversion privilege. The minimum reserve should be the excess of the morbidity costs assumed in the premium to be payable on the terminated coverages. If the rates guaranteed into the future are inadequate to meet future obligations, then additional reserves should be established. However, for cases where the experience of the case or the experience of a block of cases is reflected back to the policyholder, the dividend liability or provision for experience rating refunds is a direct offset to the need to establish an additional reserve. Also, it should be noted that the vast majority of group accident and health policies are written in conjunction with a group life policy. In the case of an experience rated package of group life and group accident and health, policyholder margins available from the group life contract may also reduce the need to establish an additional reserve. A detailed discussion of the group dividend liability and experience rating refunds may be found below.

Reserve For Future Contingent Benefits

In addition to the unearned premium reserves for all group accident and health policies, a company may be required to establish a reserve for future contingent benefits. The most common of these is for deferred maternity benefits.

Employer groups frequently have female employees leaving for maternity reasons. These employees usually leave at some time before giving birth and are not members of the group at the time their hospitalization claim is presented. For this reason, most group policies are written to insure conception rather than birth. The requirement, therefore, is that the female employee be a member of the group at the time of conception for her to receive benefits upon giving birth.

One other contingent benefit that may be set up is a special reserve for major medical policies that have a high front-end deductible, such as $5,000 to $10,000. A claim reserve may not have been established since the insureds have not used up the deductible but future contingent benefits may be in the process of building as the deductibles are satisfied.

According to the NAIC instructions, any policy having similar extension of benefits must have such a reserve. It is intended that this reserve should be set up on the assumption that all insurance under policies containing an extension of benefits will terminate on the statement date.

Other Reserve Considerations

Claim Reserves

The treatment of active life reserves for accident and health policies has been discussed in three categories — individual, group, and credit. The requirements for each category were sufficiently unique to warrant separate consideration. The standards and practices employed in the computation of claim reserves, however, are for the most part the same for individual, group, and credit and will apply jointly unless specific reference is made to one line of business.

Claim reserves are reported as accident and health reserves. Estimated amounts that would be payable after the statement date if the insured's liability were to continue represent the unaccrued benefits which make up the claim reserve. The accrued benefit, i.e., the amount payable on the balance sheet date, is reported as the claim liability in the balance sheet. Separating accrued and unaccrued portions of claims provision often is difficult because many methods of computing claim reserves generate one total amount based upon the company's past experience.

Disabled Life Reserves For Loss-Of-Time Policies

The calculation of disabled life reserves for claims with a duration of more than two years is straightforward. The disabled life factors are based upon the age of the insured at the date of
disablement, the number of months the insured already has been disabled, and the number of months remaining in the benefit period.

For claims with a duration of less than two years, there is a variety of acceptable methods for calculation. Some of them are: (a) use of the disabled life table—either a published table or one based on the insurer’s experience; (b) use of an estimate made by the insurer’s claim department for each policy (the individual judgment approach); (c) use of a “rule of thumb,” such as setting the reserve equal to the prospective claim payments for 3 1/2 times the elapsed period of disability; or (d) a combination of the first three methods.

For any method it uses, the insurer should have statistics to show that its method would (or actually did) produce adequate reserves for prior valuation periods. If the loss-of-time policy provides a waiver of premium benefit, the reserve for policies that are having their premiums waived should be included with the disabled life reserves. A portion of the liability for incurred but not unreported loss-of-time claims may be unaccrued.

A shortage in the statutorily-determined reserves for loss-of-time claims may develop, since the experience of these claims is consolidated for those of more than and less than a duration of two years. Because of the legal requirement, claims of more than two years’ duration must have tabular reserves in accordance with statutory requirements. The minimum reserves for these claims are set, therefore, and at least that amount should be reported. Consolidated experience may indicate, because of earlier terminations of payments and lump sum settlements, that these reserves are redundant. In any case, the reserve for the initial two years of incurrence must be sufficient in its own right and must not be reduced to offset a redundancy in the reserve for claims beyond two years’ duration.

Claim Reserves For Other Than Loss-Of-Time Policies

The incurred claim reserve for various hospital and medical expense coverages may have an unaccrued portion. For example, if an insured has been hospitalized for 20 days as of a given valuation date, and it was estimated that he would be hospitalized for another 10 days for the same sickness, then the reserve for the 10 days of benefits should be established as a claim reserve. In practice, a total reserve for a given claim generally will be established and then divided by some predetermined means between claim reserves and claim liability. Due to the great latitude given the insurer in determining reserves for other than loss-of-time policies, the insurer is required to provide statistics that support the adequacy of the reserves for each major line of business.

The emergence of discount and the existence of certain minimum-premium policies and excess risk reinsurance may distort the above-mentioned tests. The adequacy of reserves is also affected by other factors, such as the existence of contractual premium clauses under which the insurer can require an additional premium to be paid under certain stipulated conditions.

45. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health premiums:

CHAPTER 18 PREMIUM INCOME

Accident and Health Policies

Accident and health insurance policies typically provide a grace period after the due date for the premium to be received before the policy is terminated. If the company is relatively assured of collecting the late premium, and has established an appropriate unearned premium reserve, it is permitted to record such due and uncollected premium as an admitted asset.

On accident and health policies, other than group, with premiums payable more frequently than quarterly, all due and unpaid premiums are not admitted if more than one period premium is overdue. Group premiums more than 90 days overdue also are disallowed as an admitted asset.
If gross accident and health uncollected premiums are recorded as income and as an asset, commissions on uncollected premiums are included in the liability for unpaid commissions.

The method used for determining the amount of uncollected premiums should be the same for group as for individual policies. This usually is done by preparing an inventory of premiums billed, due prior to the statement date but uncollected. If the company pays a different rate of commission on first-year premiums than on renewals, the premiums should be grouped to facilitate the calculation of the unpaid commissions.

Because the policyholder can terminate the policy at any time simply by not paying the premium, the company should consider its lapse experience in determining the amount it records as uncollected premiums. Recording older due premiums (although not more than 90 days past due), which have little or no unearned premium reserve, may overstate the company's financial condition. Direct mail mail-order insurance is a good example of business having high lapse rates. Many companies record no uncollected premiums on these policies.

Some insurers may act as administrators of accident and health plans under which the plans bear the risk of claims. Such plans are commonly termed “administrative services only” plans and are described in this manual as “uninsured plans.” For additional discussion see Chapter 8—Other Admitted Assets.

Amounts related to uninsured plans or the uninsured portion of partially insured plans must not be reported in premiums. Conversely income relating to the insured portion of any plan must be reported as premiums.

**Generally Accepted Accounting Principles**

46. The AICPA Audit and Accounting Guide: Health Care Organizations provides the following guidance:

**Revenue**

10.04 Revenue usually is recorded when coverage is provided to an enrollee or the service is provided to a patient or resident. Revenue is classified based on the type of service rendered or contracted to be rendered. Examples of revenue include—

- Patient service revenue, which is derived from fees charged for patient care. This may be based on diagnosis related group (DRG) payments, resource-based relative value scales (RBRVS) payments, per diems, discounts, or other fee-for-service arrangements.

- Premium revenue, which is derived from capitation arrangements.

- Resident service revenue, which may be related to maintenance fees, rental fees, or amortization of advance fees.

**Accounting for Loss Contracts**

13.05 A prepaid health care provider enters into contracts to provide members with specified health care services for specified periods in return for fixed periodic premiums. The premium revenue is expected to cover health care costs and other costs over the terms of the contracts. Only in unusual circumstances would a provider be able to increase premiums on contracts in force to cover expected losses. A provider may be able to control or reduce future health care delivery costs to avoid anticipated losses, but the ability to avoid losses under existing contracts may be difficult to measure and to demonstrate. Associated entities such as hospitals, medical groups, and individual practice associations (IPAs) may enter into similar contracts with prepaid health care providers in which they agree to deliver identified health care services to the providers’ members for specified periods in return for fixed fees.
13.06 FASB Statement No. 5, *Accounting for Contingencies*, states that a loss should be accrued in financial statements when it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. Accordingly, losses should be recognized when it is probable that expected future health care costs and maintenance costs under a group of existing contracts will exceed anticipated future premiums and stop-loss insurance recoveries on those contracts. For purposes of determining whether a loss exists, the expected future health care costs include all costs other than general and administrative, selling, maintenance, marketing and interest. The term maintenance costs refers to costs associated with maintaining announcement records and processing premium collections and payments. The estimated future health care costs and maintenance costs to be considered in determining whether a loss has been incurred should include fixed and variable, direct, and allocable indirect costs. Contracts should be grouped in a manner consistent with the provider’s method of establishing premium rates, for example, by community rating practices, geographical area, or statutory requirements, to determine whether a loss has been incurred.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 18, Premium Income
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 10 - Uncollected Premium Balances
- Issue Paper No. 47 - Uninsured Plans
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 59 - Credit Life and Accident and Health Insurance Contracts
- Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts
- Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance

**Generally Accepted Accounting Principles**
- AICPA Audit and Accounting Guide: Health Care Organizations

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 55

Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS
Finalized June 23, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE


2. GAAP guidance for recording unpaid claims and unpaid losses and loss/claim adjustment expenses is substantially consistent with current statutory guidance. This guidance is found in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FAS 60).

3. The purpose of this issue paper is to establish statutory accounting principles for recording liabilities for unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts, that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). The guidance set forth in this issue paper applies to all contracts as defined in Issue Paper No. 50 - Definitions and Classifications of Insurance or Managed Care Contracts In Force (Issue Paper No. 50).

4. This issue paper does not address policy reserves for life and accident and health policies. These reserves are addressed in Issue Paper No. 51—Life Contracts, Issue Paper No. 52—Deposit-Type Contracts, Issue Paper No. 54—Individual and Group Accident and Health Contracts (Issue Paper No. 54), and Issue Paper No. 59—Credit Life and Accident and Health Insurance Contracts.

5. This issue paper does not address liabilities for punitive damages. These liabilities shall be recorded in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).

SUMMARY CONCLUSION

6. Claims, losses and loss/claim adjustment expenses shall be recognized as expense when a covered or insured event occurs. In most instances the covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. For claims made type policies the covered or insured event is the reporting to the entity of the incident that gives rise to a claim. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a
liability. The future payments associated with settling unpaid claims, unpaid losses and loss/claim adjustment expenses meet the definition of a liability as established in Issue Paper No. 5. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserves) and incurred costs, with a corresponding charge to income.

7. The following are types of future costs relating to property and casualty contracts as defined in Issue Paper No. 50, which shall be considered in determining the liabilities for unpaid losses and loss adjustment expenses:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date. As a practical matter this also may include losses that have been reported to the company but have not yet been entered to the claims system or bulk provisions. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 7 a. and 7 b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage. Loss adjustment expenses can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO):

1. DCC include defense, litigation, and medical cost containment expenses, whether internal or external. DCC include, but are not limited to, the following items:
   
i. Surveillance expenses;
   
ii. Fixed amounts for medical cost containment expenses;
   
iii. Litigation management expenses;
   
iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
   
v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
   
vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist;
   
vii. The cost of engaging experts;

2. AO are those expenses other than DCC as defined in (1) above assigned to the expense group “Loss Adjustment Expense.” AO include, but are not limited to,
the following items:

i. Fees and expenses of adjusters and settling agents;

ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;

iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and

iv. Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

8. The following future costs relating to life and accident and health indemnity contracts, as defined in Issue Paper No. 50, shall be considered in determining the liability for unpaid claims and claim adjustment expenses:

a. Accident and Health Claim Reserves: Reserves for claims that involve a continuing loss. This reserve is a measure of the future benefits or amounts not yet due as of the statement date which are expected to arise under claims which have been incurred as of the statement date. This shall include the amount of claim payments that are not yet due such as those amounts commonly referred to as disabled life reserves for accident and health claims. The methodology used to establish claim reserves is discussed in Issue Paper No. 54;

b. Claim Liabilities for Life/Accident and Health Contracts:

   i. Due and Unpaid Claims: Claims for which payments are due as of the statement date;

   ii. Resisted Claims in Course of Settlement: Liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim based on the reporting entity’s past experience with similar resisted claims;

   iii. Other Claims in the Course of Settlement: Liability for claims that have been reported but the reporting entity has not received all of the required information or processing has not otherwise been completed as of the statement date;

   iv. Incurred But Not Reported Claims: Payments for which a covered event has occurred (such as death, accident or illness) but has not been reported to the reporting entity as of the statement date;

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 8 a. and 8 b. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;
9. The following costs relating to managed care contracts as defined in Issue Paper No. 50 shall be considered in determining the claims unpaid and claims adjustment expenses:

a. Claims unpaid for Managed Care Reporting Entities:
   
i. Unpaid amounts for costs incurred in providing care to a subscriber, member or policyholder including inpatient claims, physician claims, referral claims, other medical claims, resisted claims in the course of settlement and other claims in the course of settlement;
   
ii. Incurred But Not Reported Claims: Liability for which a covered event has occurred (such as an accident, illness or other service) but has not been reported to the reporting entity as of the statement date;
   
iii. Additional medical costs resulting from failed contractors under capitation contracts and provision for losses incurred by contractors deemed to be related parties for which it is probable that the reporting entity will be required to provide funding;

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 9 a. of this issue paper. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

c. Liabilities for percentage withholds (“withholds”) from payments made to contracted providers;

d. Liabilities for accrued medical incentives under contractual arrangements with providers and other risk sharing arrangements whereby the health entity agrees to share savings with contracted providers.

10. The liability for claim reserves and claim liabilities, unpaid losses, and loss/claim adjustment expenses shall be based upon the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. These liabilities will not be discounted unless authorized by specific issue papers, including Issue Paper No. 54 and Issue Paper No. 65 - Property and Casualty Contracts.

11. Various analytical techniques can be used to estimate the liability for IBNR claims or losses, future development on reported losses/claims, and loss/claim adjustment expenses. These techniques generally consist of statistical analysis of historical experience and are commonly referred to as loss
reserve projections. The estimation process is generally performed by line of business, grouping contracts with like characteristics and policy provisions. The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of those assumptions to the circumstances. No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered.

12. For each line of business and for all lines of business in the aggregate, management shall record its best estimate of its liabilities for unpaid claims, unpaid losses, and loss/claim adjustment expenses. Because the ultimate settlement of claims (including IBNR for death claims and accident and health claims) is subject to future events, no single claim or loss and loss/claim adjustment expense reserve can be considered accurate with certainty. Management’s analysis of the reasonableness of claim or loss and loss/claim adjustment expense reserve estimates shall include an analysis of the amount of variability in the estimate. If, for a particular line of business, management develops its estimate considering a range of claim or loss and loss/claim adjustment expense reserve estimates bounded by a high and a low estimate, the best estimate of the liability within that range shall be recorded. The high and low ends of the range shall not correspond to an absolute best-and-worst case scenario of ultimate settlements because such estimates may be the result of unlikely assumptions. Management’s range shall be realistic and therefore shall not include the set of all possible outcomes but instead only those outcomes that are considered reasonable.

13. In the rare instances when, for a particular line of business, after considering the relative probability of the points within the estimated range, it is determined that no point within management’s estimate of the range is a better estimate than any other point, the midpoint within management’s estimate of the range shall be accrued. It is anticipated that using the midpoint in a range will be applicable only when there is a continuous range of possible values, and no amount within that range is any more probable than any other. For purposes of this issue paper, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be accrued. This guidance is not applicable when there are several point estimates which have been determined as equally possible values, but those point estimates do not constitute a range. If there are several point estimates with equal probabilities, management should determine its best estimate of the liability.

14. If a reporting entity chooses to anticipate salvage and subrogation recoverables (including amounts recoverable from second injury funds where applicable), these recoverables shall be estimated in a manner consistent with paragraphs 10 through 12 of this issue paper and shall be deducted from the liability for unpaid claims or losses.

15. Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3). Issue Paper No. 3 requires changes in estimates to be included in the statement of operations in the period the change becomes known.

Disclosure

16. The financial statements shall include the following disclosures for each year full financial statements are presented. Life and annuity contracts are not subject to this disclosure requirement.

a. The balance in the liabilities for unpaid claims and unpaid losses and loss/claim adjustment expense reserves at the beginning and end of each year presented;
b. Incurred claims, losses and loss/claim adjustment expenses with separate disclosure of the provision for insured or covered events of the current year and of increases or decreases in the provision for insured or covered events of prior years;

c. Payments of claims, losses and loss/claim adjustment expenses with separate disclosure of payments of losses and loss/claim adjustment expenses attributable to insured or covered events of the current year and to insured or covered events of prior years;

d. The reasons for the change in the provision for incurred claims, losses and loss/claim adjustment expenses attributable to insured or covered events of prior years. The disclosure should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects;

e. A summary of management’s policies and methodologies for estimating the liabilities for losses and loss/claim adjustment expenses including discussion of claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures;

f. Disclosure of the amount paid and reserved for losses and loss/claim adjustment expenses for asbestos and/or environmental claims, on a gross and net of reinsurance basis (the reserves required to be disclosed in this section shall exclude amounts relating to policies specifically written to cover asbestos and environmental exposures);

g. Estimates of anticipated salvage and subrogation (including amounts recoverable from second injury funds, other governmental agencies, or quasi-governmental agencies, when applicable) deducted from the liability for unpaid claims or losses.

**DISCUSSION**

17. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for recording a liability for unpaid claims and unpaid losses and loss/claim adjustment expenses. Property and casualty insurers report the liability for loss adjustment expenses separate from the liability for losses while life and accident and health insurers and managed care providers accrue such expenses as part of the claim liability, claim reserve or claims payable. The description of the types of costs considered DCC and AO are consistent with the P&C Accounting Practices and Procedures Manual adopted by Accounting Practices and Procedures (EX4) Task Force in June 1995 to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). Recording estimated salvage and subrogation recoveries continues to be optional.

18. In addition to requiring management to record its best estimate of its unpaid liability for unpaid claims, unpaid losses and loss/claim adjustment expenses for each line of business, the conclusion expands current statutory guidance to require the accrual of the midpoint of a range of loss or loss adjustment expense reserve estimates when for a particular line of business, no point within management’s range of reasonably possible estimates is determined to be a better estimate than any other point. This conclusion is consistent with Issue Paper No. 5 which states:

> When an amount within management’s estimate of the range of a loss appears to be a better estimate than any other amount within the range, that amount shall be accrued. When, in management’s opinion, no amount within management’s estimate of the range is a better estimate than any other amount, however, the midpoint (mean) of management’s estimate in the range shall be accrued. For purposes of this paragraph, it is assumed that management can quantify the high end of the range. If management determines that the high end of the range cannot be quantified, then a range does not exist, and management’s best estimate shall be used.
Additionally, the conclusion expands the disclosure requirements of current statutory guidance to include the information set forth in paragraph 16. The disclosure required by paragraph 16 provides disclosure in those circumstances where the accompanying exhibits are not part of the company’s financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

19. The conclusions above are consistent with the guidance provided for the recognition of claim costs in FAS 60 with the exception of paragraph 13 of this issue paper which requires the accrual of the midpoint of management’s estimate of the range of loss or loss adjustment expense reserve estimates when no point within management’s continuous range of reasonably possible estimates is determined to be any more probable than any other. Although FAS 60 is rejected in Issue Paper No. 50, it is considered appropriate that the recognition of claims costs be consistent with those provisions of FAS 60 as they are consistent with the Statement of Concepts. The disclosures required in paragraph 16 are consistent with the guidance in AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises. This pronouncement will be addressed in its entirety in a separate issue paper. This issue paper rejects AICPA Statement of Position 92-4, Auditing Insurance Entities’ Loss Reserves.

20. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

**Conservatism**

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

**Recognition**

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

**Drafting Notes/Comments**

- Accounting for reinsurance is addressed in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance and Issue Paper No. 75 - Property and Casualty Reinsurance.
- Accounting for title insurance is addressed in Issue Paper No. 57 - Title Insurance.
- Excess statutory reserves are addressed in Issue Paper No. 65 - Property and Casualty Contracts.
- Claims made insurance contracts are addressed in Issue Paper No. 65 - Property and Casualty Contracts.
- Mortgage Guaranty contracts are addressed in Issue Paper No. 88 - Mortgage Guaranty Insurance.
- Property and Casualty liabilities subject to discounting are discussed in Issue Paper No. 65 - Property and Casualty Contracts.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

21. The P&C Accounting Practices and Procedures Manual, Chapter 10, Losses, includes the following guidance:

Recognition

Even though there are many methods of estimating unpaid losses, the underlying goal is to have unpaid losses reflect the liability outstanding for losses that have occurred as of the financial statement date. Losses, except for “claims-made” policies, are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped in (1) reported and (2) incurred but not reported (IBNR). Reported losses are those of which the company has been notified. The incurred but not reported losses are those losses that have occurred but have not been reported to the company. As a practical matter, losses which have been reported to the company but not yet entered into the system may be included as IBNR.

Valuation

Generally, a company is required to determine what the value of its claims will be when ultimately settled. Excluding certain types of losses, discussed under Loss Reserve Discounting below, statutory accounting practices require that for every dollar of unpaid losses the company reserve a whole dollar for the future payment of those losses.

Estimation of Reported Losses Unpaid

Unpaid losses for claims that have been reported may be determined in many ways. One way is for the claim to be assigned to an individual who estimates the value of the claim as needed facts are gathered.

Shown below are three examples of methods of calculating unpaid losses, which use information that may be maintained on an accident or report year basis. If historical information is maintained and used by accident year, then the unpaid losses include IBNR unpaid losses and the IBNR unpaid losses must be split from the total. If report year data is used, then the result is an unpaid loss figure for reported claims and IBNR unpaid losses must be estimated separately.

Reported losses may be estimated based on paid loss patterns for particular lines or coverages. This method determines the pattern of prior years paid losses as they relate to ultimate losses. A percentage of paid losses to ultimate losses is calculated at each stage of development. This percentage is then divided into the paid losses for other years in the same stage of development to determine the estimated ultimate loss dollars. The paid losses are then subtracted from the ultimate loss dollars to determine the required unpaid loss amounts. The sum of these amounts for all open years is the total unpaid losses. This method, as is the case with respect to any method based in whole or in part on past experience, is only reliable to the extent there is sufficient volume of similar loss claims in prior years. In addition, changing trends and factors affecting a company’s loss liability, such as inflation and trends in jury awards, must always be carefully considered and reflected. Special problems, such as changeovers from a tort to a no-fault system, require special consideration and treatment in estimating unpaid losses.

Another means of establishing unpaid losses is to estimate ultimate loss counts and estimate the average ultimate cost of a claim. These two estimates are then multiplied by each other to establish an ultimate cost. Paid losses to date are subtracted from this ultimate cost figure to arrive at unpaid losses.

The ultimate loss count may be determined by developing a percentage of losses reported at the particular stages of development of prior years. These percentages may then be divided into current reported losses to determine ultimate numbers. This, of course, is assuming that a representative
pattern is present for prior years. The average cost of incurred losses may be determined by developing the average cost of closed claims at various stages of development. After review of prior years average closed claim cost, a factor is developed and used to project trends in total loss costs. This trend factor is then applied to the average closed claim cost of prior years to determine an estimated average ultimate cost for the year being reviewed.

Another method that may be used is unpaid loss counts and average values of unpaid losses. The average value of unpaid losses is multiplied by the unpaid loss count to arrive at an ultimate figure. From this figure, partial payments are subtracted to arrive at a current unpaid loss amount. Average values of unpaid losses are determined by reviewing prior years information as it develops.

Some of the other methods that may be used include frequency and severity analysis and projection of loss ratios.

The foregoing are examples of the many general methods in use. Also, in practice, there are many variations to these methods. Some companies use a combination of methods to establish their unpaid losses. For example, for liability losses that require a great deal of time to settle, average unpaid loss amounts may be assigned until adequate information is compiled. Then the individual case estimate methods may be used.

Incurred But Not Reported Losses

With reported losses representing the liabilities for reported claims, the company must also record a liability for losses that are incurred but not reported. Various methods are used for estimating IBNR losses. Following are examples of two methods.

In a formula method, IBNR losses are related to some base, such as incurred losses, reported losses, premiums and exposures. Sometimes a formula approach is used in estimating total unpaid losses and the IBNR losses are separated from the reported losses by factoring.

In the averaging method, separate projections are made of IBNR claim counts and the average cost for which those claims will settle. The product of these two estimates is the IBNR unpaid losses.

Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy.

Recoveries from Salvage and Subrogation

Anticipated salvage and subrogation may be taken into account when determining ultimate incurred losses and unpaid losses, to the same extent that other factors affecting ultimate claim costs are taken into account. The company is expected to maintain appropriate data and perform appropriate actuarial tests to support the reasonableness of the anticipated salvage and subrogation recoveries.

Companies which have previously reported reserves gross of salvage and subrogation should report the change to the net method as a change in accounting principle. The cumulative effect on prior years of the change should be reported as a write-in item in the surplus section of the annual statement. The change in reserve calculated using the net method should be included in net income for the year of the change and all future years.

22. The P&C Accounting Practices and Procedures Manual, Chapter 11, Loss Adjustment Expenses, includes the following guidance:

The liability for unpaid loss adjustment expenses includes expenses that will be incurred in connection with the settlement of losses unpaid at the statement date. The liability should be the company's best estimate of the loss adjustment expenses that will be necessary to settle both reported and incurred but not reported unpaid losses. In addition to these expenses, the company must establish a liability for incurred but unpaid loss adjustment expenses, the same as for incurred
and unpaid general expenses. The liability for unpaid loss adjustment expenses should provide for the estimated expenses necessary to adjust all unpaid losses irrespective of payments made to third party administrators, management companies or other entities, not specifically covered by a contract of insurance.

Allocated Loss Adjustment Expenses

Allocated unpaid loss adjustment expenses are calculated by various methods. Examples of methods used are as follows:

Calendar year paid allocated loss adjustment expense is related to the calendar year paid losses. The ratio developed on the basis is then multiplied by the amount of the loss reserve for each of these coverages to determine the unpaid amount.

Another method tracks accident year development and computes a ratio on an incurred-to-incurred basis. Prior accident years data is accumulated at various stages of development. The ratio of accumulated allocated loss adjustment expense paid to accumulated losses paid is calculated at each stage of development. This process should start with the oldest accident year and move forward. The ratio of paid-to-paid for each accident year under review is then compared to the paid-to-paid ratios for prior accident years at the same stage of development. After this comparison, the estimated ultimate incurred-to-incurred ratio is projected for the accident year under review, based on the subsequent development of prior years’ paid-to-paid ratios. The estimated incurred losses for the accident year under review are then multiplied by the incurred-to-incurred ratio to determine ultimate allocated loss adjustment expense amounts. Paid allocated loss adjustment expense is then subtracted to arrive at the unpaid amount. This method recognizes that older claims may require larger amounts of loss expenses.

The liability-to-liability ratio method establishes the liability directly by multiplying the estimated loss liability for each accident year by an estimated liability-to-liability ratio (allocated loss adjustment expense liability to loss liability). It starts by calculating the liability-to-liability (outstanding-to-outstanding) ratios that should have been used in prior accident years at the same stage of development. These prior ratios are then reviewed, and an outstanding-to-outstanding ratio is selected for the accident year involved.

Again, if allocated loss adjustment expense levels increase with age, then the outstanding-to-outstanding ratios will increase with age up to some cut-off age. The selected outstanding-to-outstanding ratios by accident year have no permanence and must be reselected at the end of each new accounting date. This method also requires the maintenance of accident-year data on an all-time cumulative basis through each stage of development.

Unallocated Loss Adjustment Expenses

A commonly used method of calculating unpaid, unallocated loss adjustment expenses computes a paid, unallocated expense ratio to paid losses. Based on this paid-to-paid ratio, each coverage is reviewed as to the percentage of unallocated handling that is complete at the time the claim is opened. This percentage is subtracted from 100% to determine the work that remains to be done. This percentage is then multiplied by the developed paid-to-paid factor. The factor that results from this calculation is then multiplied by the outstanding unpaid losses to determine the unpaid, unallocated loss expenses.

For IBNR paid losses, the full paid-to-paid factor is normally used to determine unpaid, unallocated loss adjustment expenses. This is done because these claims have not been opened and therefore little, if any, work has been completed.

Unpaid loss adjustment expenses are shown as a liability on the annual statement.
23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 11, Unpaid Life Insurance Claims, provides the following guidance:

**Life Insurance Claims**

A life insurance contract provides a death benefit, an annuity benefit, or an endowment benefit. The company knows (with few exceptions) the amount of its obligation to each policyholder when it is presented with a claim or when the policy matures. At any statement date the company will owe unpaid policy proceeds which must be provided for in its financial statements.

In addition to the proceeds of the basic contracts, amounts may be payable for supplementary benefits attached to the basic contracts. These include accidental death benefits, payor death or disability benefits, premium waiver as a result of the disability of the insured, and in some instances, disability income benefits. As with the basic contract, the amount of accidental death benefits payable is a fixed amount, known to the company, once the criteria for payment has been established. Payor death requires reserving a specific number of premium payments contingent upon the insured living to a certain age. Payor disability, premium waiver, and disability income require the establishment of reserves based on appropriate morbidity factors and mortality factors. All or part of these reserves may be included in unpaid claims at statement date.

For all practical purposes, payment of life insurance claims and the accrual of the liability for unpaid claims is the same for ordinary, industrial, and group coverages. The liability for unpaid claims consists of both reported and unreported claims. The instances where a company may not be able to make an exact determination of its liability for a life insurance claim might include claims that are being resisted by the company and those involving an accidental death of the insured.

The liabilities that are reported in the statutory financial statement include the following:

1. Due and unpaid. This item consists of claims on which all processing has been completed and which have been approved for payment, but which have not been paid prior to the statement date. The reported amount may be compiled from a claims register, an inventory of such claims, checks requested, or possibly drafts outstanding and, with an expeditious claims-paying system, may be small or zero.

2. Claims in course of settlement: resisted. This item contains the liability for claims that are in dispute and are unresolved on the statement date. The liability either may be the full amount of the submitted claim or a percentage of the claim that is based on the past experience of the company with similar resisted claims. The company should also accrue at year end for the estimated additional expenses (legal, investigation, etc.) involved in settling resisted claims. This latter item is included with other general expenses in the statutory financial statement.

3. Claims in course of settlement: other. These are claims that have been reported to the company but on which all required information has not been received, or the processing not otherwise completed, on the statement date. The company may include all claims that are being held up for reasons beyond its control. These may include awaiting the election of an option by a beneficiary, the completion of reasonable investigation, or determining who is entitled to receive the amount due. The amount of the liability may be based on the past experience of the company but it generally is a compilation of the claims that are pending at the statement date.

4. Incurred but not reported (IBNR) claims. This represents the company's liability for claims that have not been reported to it but the insured had died or become disabled prior to the statement date. At the end of the year the liability for IBNR claims may be estimated using any of the following techniques or any other technique which has proved reasonable for the particular company:

   a. Establish a cut-off period of a few weeks subsequent to year end and complete a list of all claims received during the cut-off period that relate to the prior year and then determine the liability for those claims using the same methods as for claims in the course of settlement.
b. Inventory the prior years IBNR claims that were received after the prior years cut-off period and on the basis of past experience, estimate those claims that will be reported thereafter.

c. Analyze the past years experience and project it into the future after considering various modifying factors, such as insurance in force, paid claims, and claim frequency and severity. This should be done by the company’s actuary to ensure that all current actuarial assumptions and methods are used.

The policies on which claims have been incurred but not reported until after the statement date will be included in the valuation of insurance in force. By reserving the face amount of the policy as an IBNR claim, the reserve for IBNR claims would be redundant. The policy reserves on those claims, therefore, are deducted either from the aggregate reserves for life policies or from the IBNR claim reserve.

24. The Life/A&H Accounting Practices and Procedures Manual, Chapter 14, Accident And Health Claims provides the following guidance:

Accident and health insurance policies generally provide for the coverage of such benefits as hospital and medical payments, disability and loss of time (income), and accidental death and dismemberment. Claims on accident and health policies are payable in the manner dictated by the risk that is insured. Usually, hospital and medical and accidental death and dismemberment claims are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims, for partial or total disability due to accident and sickness, are paid to the insured weekly or monthly during the period of disability, or a settlement may be reached between the company and the insured for a discounted lump sum payment.

The insurer’s claims reserves should not include any amounts arising from uninsured accident and health plans or the uninsured portion of partially insured plans. The insured portion of any partially insured plan should be treated as any other insured plan with appropriate reserves established. This is the same treatment described with regard to aggregate reserves in Chapter 13.

Claim Liabilities and Reserves

Unpaid benefits on accident and health policies are discussed in this chapter and Chapter 13. Amounts that would not be payable on the statement date (the unaccrued portion) are detailed in Chapter 13 as claim reserves. The amounts that are payable on the statement date (the accrued portion) are covered below as claim liabilities.

The various methods described in the following paragraphs are not an exhaustive listing, nor are the descriptions of such methods necessarily complete.

Due and Unpaid Claims

The instructions for completing the statutory financial statement for life and accident and health companies state that only claims which are complete except for the payment of the amount due should be included. Claims that have not been paid, because all of the required information has not been received, should be included with claims in course of settlement. The amount of due and unpaid claims generally will be small. The amount of the liability usually is determined on an exact inventory basis of claims on hand ready to be paid. In practice, a seriatim calculation of this liability is very difficult. Many companies take the approach that if all information is available to pay a claim then it has been paid. All claims on which the Company has only partial information are reported as “Claims in course of settlement.”

Claims in Course of Settlement: Other

This item includes the liability for resisted claims in the amount the insurer expects the claim to be settled and paid. The accrued claim liability for all unresisted claims also is included.
For loss-of-time (disability income) policies, the accrued portion of the next periodic payment must be included. For example, when payments on a claim are made to the insured on the fifteenth day of each month and when the valuation date is the end of the month, one-half of the monthly payment is accrued, but not yet due, on the valuation date if the insured is still disabled on the valuation date.

One method is to set up a reserve equal to one-half of all monthly payments being made for loss-of-time policies. A more accurate method to determine the accrued and unpaid liability on reported disability claims is to compute the total amount accrued to the valuation date for each claim, then subtract the amount that already has been paid.

For other than loss-of-time policies, various methods are used in determining liabilities for these claims. Because these methods may produce total claim liabilities, a breakdown between unaccrued and accrued amounts should be made for allocation between claim reserve and claim liability. Although not intended to be a complete list, the following are examples of these methods:

1. An estimate may be made for each outstanding claim. Generally, this is not feasible unless the number of claims is relatively small.

2. Average claim factors may be developed from actual claim experience on similar claims outstanding at previous statement dates. To determine the total liability, these average factors are applied to the current outstanding claims. The calculation of factors, and their application to outstanding claims, should be done separately for each major type of benefit. Furthermore, the average claim factors should recognize the effects of inflation.

3. A formula method determines the adequacy of the claim liability at previous statement dates and of the total claims incurred on a line of business through retrospective studies. The amount of claims paid is related to a pre-established base, such as premium in force, unearned premium reserve, and so on. The percentages developed are applied to the same base on the statement date to develop the current liability. The formula method may be desirable, also, because it can include a provision for the liability for claims incurred but unreported.

**Incurred But Not Reported (IBNR) Claims**

The formula method, previously described for computing claims in course of settlement, probably is the most commonly used method to calculate this liability. Another method, sometimes called the lag system, is based on the assumption that a significant portion of the incurred but unreported claims will be reported within a specified period after the statement date. Under this method, the insurer establishes a liability for the claims reported, plus an estimated amount for claims reported after the “lag” period. The instructions for preparing the statutory financial statement contain an illustration of a method for computing the reserve for future contingent benefits, i.e., deferred maternity benefits.

For any method that is used, the insurer should verify the appropriateness of the IBNR liability by retrospectively calculating the exact amount of the liability for past valuation period.

**Statistical Computation**

The statistics developed from prior experience are essential in computing the claim reserves on accident and health policies. The important dates required for individual claims include the incurred date of the claim, the reported date, and the date of the claim payment.

The reported date is the date the claimant notified the company and a claim file is opened. The payment date may be either the date the partial payment is made or the date the final payment is made.

The incurred date must be defined by the contract and any applicable statute for various coverages. For example, for deferred maternity benefits, the incurred date is the date of conception. For major medical coverages, the incurred date should take into account the date of disability, the date the
initial expense was incurred, and the date the deductible was satisfied, if and as these features affect
the company’s contractual obligation under the claim. Hospital and surgical policies present less of a
problem because either the date of admission to the hospital or the surgery date is utilized as the
incurred date.

If subsequent treatment for the same condition falls within the definition of one illness, as set forth in
a hospital, medical, or major medical contract, the original incurred date must be used and any
payments considered part of the original claim. In summary, the assignment of incurred dates must
bear a logical relationship to the situation creating the claim and must be consistently applied from
year to year and is generally the date of the first compensable treatment.

In regard to loss-of-time disability policies with an elimination period, the duration of disablement shall
be considered as dating from the time that benefits would have begun to accrue had there been no
elimination period.

Reinsurance

On policies that have been reinsured, the liability for claims should be reduced by the amount
recoverable from the reinsurer. The amount of reinsurance that is recoverable on claims relating to
specific policies should be reported at actual amounts. For incurred but unreported claims, the liability
should be estimated net of reinsurance recoverable, unless the company has reliable experience
supporting an estimated separation into direct and reinsurance ceded portions. The latter situation
usually arises under quota share group reinsurance.

25. The HMO Accounting Practices and Procedures Manual, Chapter 8, Liabilities, provides the
following guidance:

LIABILITIES

COVERED AND UNCOVERED LIABILITIES

Any liability for health care expenses for which an enrollee is not responsible in the event of the
insolvency of an HMO is deemed to be a covered liability. One method of assuring that an enrollee
will not be liable for unpaid medical bills if an HMO becomes insolvent is through a “hold harmless”
provision contained in provider contracts. This provision prohibits the provider from seeking payment
for medical expenses directly from the enrollee. At present there is a standardized hold harmless
agreement adopted as a “guideline” by the National Association of Insurance Commissioners and the
National Association of Health Maintenance Organization Regulators and is an attachment to the
Model HMO Act.

If this provision is present in provider contracts, then the medical expense for that provider is
considered to be a covered liability.

Uncovered Liabilities

Uncovered liabilities are defined as those expenditures that are covered by the HMO for which an
enrollee would also be liable in the event of the organization’s insolvency. These are expenditures for
health care services for which the HMO is at risk. They do not include expenditures for services when
a provider has agreed not to bill the enrollee even though the provider is not paid by the HMO, or for
services that are guaranteed, insured or assumed by a person or organization other than the HMO.

When preparing its annual statement, an HMO must determine the amount of both the covered and
uncovered liabilities and report such amounts in the columns provided in the annual statement blank.
The instructions to the annual statement also provide that the HMO describe in the notes to the
financial statements the manner in which each liability reported as covered has been covered, i.e.,
hold harmless agreement, parental guarantee, etc.
Accrued and Unpaid Claims

The establishment and maintenance of adequate reserves is essential to the successful management of an HMO. Claim reserving techniques must be sufficient to project the amount of claims outstanding at the end of each financial reporting period. The amount reported should include provisions for claims that are known and pending as well as for claims incurred but not reported (IBNR).

The statutory annual statement blank contains a schedule for reporting the various parts of the unpaid claim liability. This is titled Schedule F, "Unpaid Claim Analysis." The Unpaid Claim Analysis consists of two parts. Section 1 is used to report unpaid claims for the current year by line of business. For purposes of completing this report, claims are classified into four distinct types:

- Inpatient Claims
- Physician Claims
- Referral Claims
- Other Medical Claims

The information contained in Section 2 of Schedule F provides for an analysis of the claims unpaid for the prior year as reported on the previous year’s annual statement. The purpose for including this section is to measure the adequacy of the claim reserves established in the prior year’s annual statement by comparing the actual amount paid in the current year against the reserves that were previously established.

In Section 1 of Schedule F, column 2 is used to report the aggregate amount of claims in process of adjustment by classification; column 3 is used to report the estimated liability by classification for claims incurred but unreported (IBNR). The aggregate total of claims in the process of adjustment and the provision of IBNR claims is shown in column 4.

Before delving further into a discussion on developing incurred but not reported reserving techniques, it is important to review lines of business and determine what should be reported in each line. The following schedule reflects the various lines of business and indicates the nature of claim cost that should be reported under each line:

<table>
<thead>
<tr>
<th>LINE OF BUSINESS</th>
<th>NATURE OF CLAIM COST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inpatient Claims</td>
<td>Inpatient hospital costs of routine and ancillary services for HMO members while confined to an acute care hospital. Does not include out-of-area hospitalization. Routine hospital service includes regular room and board (including intensive care units, coronary care units, and other special inpatient hospital units), dietary and nursing services, medical surgical supplies, medical social services, and the use of certain equipment and facilities for which the provider does not customarily make a separate charge. Ancillary services may also include laboratory, radiology, drugs, delivery room and physical therapy services. Ancillary services may also include other special items and services for which charges are customarily made in addition to a routine service charge. Charges for non-HMO physician services provided in a hospital are included in this line item only if included as an undefined portion of charges by a hospital to the HMO. (If separately itemized or billed, physician charges should be included in referrals, above.) Include the cost of utilizing skilled nursing and intermediate care facilities.</td>
</tr>
</tbody>
</table>
Skilled nursing facilities are primarily engaged in providing skilled nursing care and related services for patients who require medical or nursing care of rehabilitation service. Intermediate care facilities are for individuals who do not require the degree of care and treatment which a hospital or skilled nursing care facility provides, but do require care and services above the level of room and board.

**Physician Services**

Expenses for physician services provided under contractual arrangement to the HMO including the following:

<table>
<thead>
<tr>
<th>LINE OF BUSINESS</th>
<th>NATURE OF CLAIM COST</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>− Salaries, including fringe benefits, paid to physician for delivery of medical services;</td>
</tr>
<tr>
<td></td>
<td>− Capitated payments paid by the HMO to physicians for delivery of medical services to HMO subscribers;</td>
</tr>
<tr>
<td></td>
<td>− Fees paid by the HMO to physicians for delivery of medical services to HMO subscribers. This includes capitated referrals; (Do not include expenses for medical personnel time devoted to administrative tasks.)</td>
</tr>
</tbody>
</table>

Compensation, including fringe benefits, paid by the HMO to non-physician providers engaged in the delivery of medical services and to personnel engaged in activities in direct support of medical services. This includes dentists, psychologists, optometrists, podiatrists, externs, nurses, clinical personnel such as ambulance drivers, technicians, paraprofessionals, janitors, quality assurance analysts, administrative supervisors, secretaries to medical personnel, and medical clerks.

**Referrals**

Expenses for providers not under HMO arrangements such as consultations.

**Other Medical**

Costs directly associated with the delivery of medical services under HMO arrangements which are not appropriately assignable to the medical expense categories defined above; e.g., costs of medical supplies, medical administration expense (except compensation), malpractice insurance, etc.

Expenses for other non-contracted health delivery services including emergency room costs incurred by HMO members for which the HMO is responsible on a fee-for-service basis; and out-of-area service costs for emergency physician and hospital.

Another important aspect in reporting claim liabilities is to include only liabilities relating to actual amounts due providers or enrollees for health care services. Items consisting of withholds or the provision for withholds should be reported as a separate liability in the annual statement. Further, claims payable or claims incurred but not reported (IBNR) are not to be adjusted for amounts receivable from other HMOs or indemnity carriers such as coordination of benefits or subrogation. Such receivables are to be reported as an income item in the period received.

**Determining IBNR Claims**

There are a number of methods used to develop IBNR reserves. Two of the most common are the lag system which is based on the assumption that a majority of claims to be incurred will be reported within a given number of months after the statement date. Under this method, an HMO bases its...
reserve on an estimate of the reported claims within a specific time following the statement and it includes an amount for claims reported after the “lag” period. A second method bases claims on the development of prior years IBNR results and adjusts this amount for any increase or decrease in business and for the impact of inflation.

Regardless of the method used to develop IBNR claims, the method used should be tested through a retrospective analysis of claims for past periods.

**Accrued Medical Incentive Pool**

This amount represents the accrual for withhold from IPAs or are a “risk bonus” in capitated medical groups or other such arrangement in which the HMO may return incentive funds to providers. This liability shall not include percentage withholding from providers which should be reported separately. The amount due should be supported by signed agreements and the basis for establishing the liability should be documented when determining the amount of this liability.

**AMOUNTS WITHHELD FOR RISK SHARING**

These amounts are also included in amounts withheld from providers, generally in a capitated fee arrangement, requiring the provider to share the risk in the event of adverse claim costs. These amounts are held pursuant to a written arrangement which outlines the circumstances under which the so-called gain or loss on the capitated arrangement has been determined. The amounts reported may carry over from one period to another and it may be difficult to determine. HMOs should maintain data to support the amounts withheld on an annual basis, as well as information to support all disbursements.

26. The minutes of the June 6, 1995 meeting of the Accounting Practices and Procedures (EX4) Task Force indicate the Task Force has adopted changes to Chapter 11, Loss Adjustment Expenses and Chapter 17, Loss Adjustment Expenses Incurred of the P&C Accounting Practices and Procedures Manual to be effective for calendar years beginning January 1, 1997 (later revised to January 1, 1998). The revised chapters are presented below:

**CHAPTER 11**

**LOSS ADJUSTMENT EXPENSES**

Every property/casualty insurer is required to maintain reserves in an amount estimated to provide for the expenses of adjustment or settlement of all losses or claims incurred on or prior to the date of statement, whether reported or unreported, which are unpaid as of such date and for which the insurer may be liable. The loss adjustment expense reserve maintained should be established at an amount which is irrespective of any payments made to third-party administrators, management companies, managing general agents, or other entities not specifically covered by a contract of insurance.

Loss adjustment expenses are categorized as “allocated” or “unallocated.” Separate data is shown relative to payments of these expenses and separate reserves are required to be stated for each component within Schedule P of the Annual Statement blank. Relative to allocated loss adjustment expenses, separate reserve provisions are required to be shown for known case reserves and incurred but not reported reserves, and for each of the segments, there is a further requirement to show reserves for direct plus assumed business as well as the ceded portion of those reserves. The actuarial techniques existent for determining the reserves required for each of these components are more precise relative to the allocated expenses because the payments and reserves history are more precisely apportioned to loss years and are thus more homogeneous. Unallocated loss adjustment expenses paid, apportioned to loss year based on formula, are less likely to present data with the same measure of homogeneity.
Allocated loss adjustment expenses can be identified with a particular claim and thus can be linked to the particular loss year underlying such claim. (Note: relative to claims-made type policies, claims are distributed on the basis of report year, i.e., the year a loss is reported to the insurer rather than the year in which the claim was incurred).

See Chapter 17 - Loss and Loss Adjustment Expenses Incurred for a description of the component parts of “Allocated Loss Adjustment Expenses.”

The reserve for unallocated loss adjustment expenses should be apportioned to loss year. This apportionment may be based on a formula or formulas containing such items as claim counts or paid to paid patterns that reflect experience for the company and the line of business.

In circumstances involving reinsurance where the definition of allocated loss adjustment expense contained in the contract is consistent with the definition in Chapter 17, it is expected that there would be symmetry of annual statement presentation. In certain instances, where reinsurance contracts define expenses to be covered thereunder differently than the definition of allocated loss adjustment expenses in Chapter 17, there may be a difference in the classification of these expenses between the ceding and assuming parties.

In reviewing the adequacy of an insurer’s loss adjustment expense reserves, it is important to group same homogeneously for proper analysis. This may require additional groupings other than the allocated and unallocated categories presented in the financial statements. Also of critical importance, is an evaluation of the company’s claims handling procedures over time to discern changes in methods of claims handling, e.g., switching from outside counsel to in-house attorneys.

Frequently, the categories of loss adjustment expense are analyzed by reference to arrays of data by line of insurance that related such expenses to other parameters, such as paid losses, incurred losses or earned premiums. Accordingly, the examination of loss adjustment expense reserve requires some or all of the following procedures:

1. Evaluation of prior developments of reserves;
2. Evaluation of known case reserve adequacy patterns;
3. Evaluation of timing patterns of expense payments in terms of how billings are made as well as the philosophy of claims handling;
4. Notation of any material end-of period transactions which might distort analysis, e.g., major claim settlements;
5. Evaluation of premiums earning procedures or changes which might reflect new forms of policy issuance such as the issuance of cash-flow type policies.

Evaluation of the reasonableness of loss adjustment expense reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves. The most typical utilized data arrays for allocated loss adjustment expenses usually present cumulative payments therefore, either separately or in relationship to cumulative loss payments. Ultimate payments or ratios are then calculated and current reserves are computed either by subtracting payments to date from projected ultimate payments or by applying the ultimate ratio to projected ultimate losses and then subtracting allocated loss adjustment expense paid to date.

Relative to unallocated loss adjustment expenses, a common method is to relate such cumulative payments by loss year to a common base, usually earned premium. Ultimate ratios of unallocated loss adjustment expenses to earned premiums are calculated. These ultimate ratios are then multiplied by the related calendar years’ earned premiums with cumulative payments to date subtracted to arrive at the required reserves. The use of earned premiums as a base allows for reasonableness tests for a particular insurer as between years as well as amongst insurers, and is rooted in earned premiums being representative of exposures. This has its limitations in that the
amount of such earned premiums is not adjusted for premium adequacy level changes and premium adequacy levels may be inconsistent. (Note: if premium adequacy/inadequacy levels are consistent, the use of earned premiums as base or benchmark will not necessarily result in distorted conclusions). In other words, doubled earned premium volume could mean doubled policy exposure and therefore doubled claims adjusting overhead, doubled premium adequacy with not concomitant claims adjusting overhead increase or somewhere in-between.

CHAPTER 17

LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

Losses Incurred

Losses incurred are reported in the Underwriting and Investment exhibits of the annual statement. Losses incurred are shown in a separate exhibit in the annual statement by adding the current year change in unpaid losses to the paid loss amount for the current year. The paid figure is direct paid losses, plus assumed paid losses, less ceded paid losses. Unpaid loss changes are also calculated on a basis net of reinsurance.

Loss Adjustment Expenses Incurred

Loss adjustment expenses incurred as presented in the annual statement comprise all expenses incurred in connection with the adjustment and recording of policy claims.

They include the total of the expense classification “Claim Adjustment Services” and the types of expenses incurred by company employees in connection with the adjustment and recording of claims. Examples of expenses incurred in these activities are estimating the amounts of claims, disbursing claims, maintaining records, general clerical, secretarial, office maintenance, supervisory and executive duties, supplies, and postage.

Loss adjustment expenses are either “allocated” or “unallocated.” Allocated expenses are those that can usually be related to specific claims. Typically they are “Claim Adjustment Services” as modified to include defense, litigation and medical cost containment expenses, whether internal or external, including overhead, and to exclude fees and expenses of all adjusters and settling agents.

Allocated loss adjustment expenses are adjusted for reinsurance assumed and ceded in accordance with the terms of applicable reinsurance contracts. In addition, an assuming reinsurer may incur expenses in its adjustment of reinsured losses. Such expenses for “Claim Adjustment Services” modified as described above are also to be treated by the reinsurer as allocated expenses.

Unallocated expenses are those expenses other than allocated expenses as defined above assigned to the expense group “Loss Adjustment Expense.”

For further information on allocation of expenses, see Chapter 19 - Expenses.

Uninsured Accident and Health Plans

See Chapter 14 - Premiums for the discussion of uninsured accident and health plans and partially insured accident and health plans.

Loss paid by the insurer under uninsured accident and health plans should not be reported in the underwriting and investment exhibits. Loss payments under the insured portion of partially insured plans are reported as accident and health losses.
27. The Minutes of the September 23, 1997 meeting of the Casualty Actuarial (Technical) Task Force contain the following:

Casualty Actuarial (Technical) Task Force
Clarification of Revised ALAE Definition

INTRODUCTION

The Casualty Actuarial (Technical) Task Force (CATF) has extensively studied the issue of financial reporting inconsistencies that occur because of the different business procedures applied by insurers to settle claims. To increase the consistency of reporting between insurers, the task force recommended to the NAIC’s Accounting Practices and Procedures (EX4) Task Force that a revised ALAE definition be adopted. The change was adopted by the Accounting Practices and Procedures (EX4) Task Force to be effective Jan. 1, 1998. The rule will be moved to the Annual Statement Instructions as it is deemed to be more of a financial reporting issue than an accounting guidance issue. The task force intends that the revised definition change the emphasis from assignment of claim expenses based on whether they could be specifically assigned to a single claim to a process where “Claim Adjustment Services” including defense, litigation and medical cost containment are assigned to the bucket or hopper currently known as “allocated loss adjustment expenses—ALAE” and remaining expenses associated with adjusting and recording policy claims are assigned to a bucket or hopper currently known as “unallocated loss adjustment expenses—ULAE.” The titles containing the terms “allocated” and “unallocated” seem to be causing difficulties for those attempting to understand the revised definition because they associate the term “allocated” with assignment or tying the expenses to a specific claim. As a result, the CATF intends to pursue a future Blanks Proposal to change the titles. The ability of an insurer to assign a particular type of expense to a single claim is no longer the determining factor as to whether the claim expenses will deemed to be ALAE or ULAE. The goal of the task force in suggesting the change is to have consistent reporting of expenses related to defense, litigation and medical cost containment among the various companies. Thus whether a company uses its own employees or hires outside firms no longer matters.

THE REVISED RULE

The Annual Statement Instructions are amended (effective 1/1/98) to include a specific delineation between allocated and unallocated loss adjustment expenses, which states:

Allocated loss adjustment expenses include defense, litigation and medical cost containment expenses, whether internal or external. Allocated loss adjustment expenses include the following items:

i. Surveillance expenses;
ii. Fixed amounts for medical cost containment expenses;
iii. Litigation management expenses;
iv. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by accident year;
v. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in defense of a claim, and fees or salaries for rehabilitation nurses, if such cost is not included in losses;
vi. Attorney fees incurred owing to a duty to defend, even when other coverage does not exist; and
vii. The cost of engaging experts.

The foregoing list is not intended to be all inclusive.

Unallocated loss adjustment expenses are those expenses other than allocated expenses as defined above assigned to the expense group “Loss Adjustment Expense.” Unallocated loss adjustment expenses include the following items:
i. Fees of adjusters and settling agents;
ii. Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year;
iii. Attorney fees incurred in the determination of coverage, including litigation between the insurer and the policyholder; and
iv. Fees or salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster.

The foregoing list is not intended to be all inclusive.

GUIDANCE IN ASSIGNING CLAIM ADJUSTMENT EXPENSES

The Casualty Actuarial (Technical) Task Force has been asked to provide additional guidance to clarify how various expenses should be classified once this change is implemented. As a result, several questions have been raised about the classification of Loss Adjustment Expenses. The questions and suggested answers follow:

1. Should surveillance expense be classified as ALAE, consistent with the NCCI’s classification?

   Answer: Yes, even though an apportionment among the claims may be required.

2. Please confirm that litigation management expenses, i.e., costs incurred to conduct audits of outside legal bills for cost containment expenses, should be classified as ALAE.

   Answer: Yes, even though an apportionment among the claims may be required.

3. Should fixed amounts for medical cost containment expenses, such as medical bill review, that are not identified to specific claims be classified as ALAE or ULAE?

   Answer: ALAE, even though an apportionment among the claims may be required. Note: medical cost containment expenses could be included in losses.

4. Certain voluntary and involuntary market pools (USAIG, MAELU, and JUAs) do not provide a split of LAE. How should they be treated?

   Answer: ALAE if reported by accident year; ULAE if reported by calendar year.

5. What is the definition of an adjuster? Does it include appraisers, rehabilitation nurses, private investigators, hearing representatives, reinspectors or fraud investigators?

   Answer: Any of the above are ALAE if they are working in defense of a claim. Any of the above are ULAE if they are working in the capacity as an adjuster, except for rehabilitation nurse expenses, which are ALAE. Note: rehabilitation nurse expenses could be included in losses.

6. If an attorney engages in adjustment activities, should the attorney’s expense be classified as ULAE?

   Answer: Yes

7. Do attorney expenses include expenses incurred in securing an opinion regarding matters of coverage, to defend denials of coverage or to evaluate issues of coverage?

   Answer: Expenses incurred in the determination of coverage, including litigation between the insurer and the policyholder, are ULAE. Defense expenses incurred owing to a duty to defend, even when other coverage does not exist, are ALAE.
8. Are experts’ expenses (doctors, engineers, architects, etc.) ALAE or ULAE? How about outside appraisers? These expenses do not fall neatly into the defense, litigation, medical cost containment or adjuster categories.

Answer: (a) the costs of experts are either ALAE or included in losses. (b) the costs of outside appraisers are ULAE unless the appraiser is working in defense of a claim in which case the costs are ALAE.

9. Does legal overhead for a subsidiary with its own law department (for example, charges passed down to a subsidiary from a corporate law department) become ALAE? If so, at what level must this data be captured (company, claim, product, coverage, etc.)? What is the meaning of overhead? Would it pertain to salaries/benefits etc. of staff associated with the above activities?

Answer: (a) ALAE. The fees charged should include overhead, just like an outside firm charges. Overhead should include the proportionate cost of floor space and associated staff salaries in the same manner as an outside law firm . (b) the level of detail should be enough to prepare Schedule P.

10. NAIC defines ALAE as expenses that can be related to specific claims. Why would Claims Adjuster expenses (e.g., Travel to a specific claim site, etc.) which can be related to a specific claim be excluded?

Answer: The first sentence in this question is inaccurate. The apportionment of claims expenses is not dependent on whether the expenses can be related to specific claims. Claims adjuster expenses are ULAE.

11. What is the NAIC’s definition of “defense expense”? 

Answer: Defense expense includes all expenses to defend claims, excluding adjuster expenses.

ADDITIONAL COMMENTS

a) There is no special concern about any potential tax problems, but there could be slight tax effects.

b) This new definition of ALAE/ULAE is not retroactive. However, prospectively the change could be implemented on a calendar year or an accident year basis. On a calendar year basis, the expenses in the new and older accident years have the new definition as they develop in the loss and expense triangles. On an accident year basis, the expenses in the new accident years have the new definition and the expenses in the older accident years have the old definition. It is optional to the company which way to do it. There is a split among companies as to which is easier. The actuary should be able to handle either way as long as it is known which choice was made. This information should be disclosed in Interrogatory 8 of Schedule P.

c) The old 45/5 rule for reporting ULAE payments was repealed by a CATF Blanks proposal which was adopted and effective with the 1997 Blank. Insurers should now apportion ULAE payments and reserves by year based on claim counts. For instance, the old rule was based mostly on the theory that 50% of the calendar year ULAE should be assigned to the year in which the claim file was opened (the current year) and 50% to the year in which it was closed. An insurer could now base the apportionment of payments and reserves by the number of claims outstanding, the number of claims reported, etc., or any relationship which seems appropriate. The ALAE payments and reserves are assigned to the accident year of the claim. When ALAE payments and reserves are apportioned, they should be apportioned based on dollars, not claim counts.

d) The task force will also consider a proposal to rename ALAE and ULAE.
28. The Minutes of the June 21, 1993 Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following with respect to non-renewable accident and health contracts:

The consensus of the working group was that the presence of non-renewal provisions or expense incurred provisions in accident and health policies does not eliminate the requirement to establish sufficient reserves at a financial statement date to cover the estimated duration of an incurred illness under this type of policy.

29. The Minutes of the June 23, 1998 meeting of the Casualty Actuarial (Technical) Task Force contain the following:

1. Discuss Issues Related to the Implementation of the Definition of ALAE/ULAE

Richard J. Roth, Jr. (Calif.) reported that inquiries related to the Jan. 1, 1998 implementation of a definition of allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE) had dropped off dramatically. He believed that the definition was achieving its intended goal to provide more uniform reporting of information in Schedule P. He believed that regulatory actuaries would benefit from obtaining data that more closely matches expenses between insurers.

Elise Liebers (N.Y.) reported that she and Judy Pool (Ill.) had volunteered to address the various names selected to replace the terms “ALAE” and “ULAE” to coincide with the new definition. She advised that they had considered several proposals. A proposal by James F. Golz (Wausau) suggested ALAE be renamed Special Claim Adjustment Expense (SCAE) and that ULAE be renamed General Claim Adjustment Expense (GCAE). A proposal by Mr. Roth suggested that ALAE be renamed Defense and Cost Containment (DCC) and that ULAE be renamed Adjusting and Other (AO). Ms. Liebers added that an informal contest was also held to select a name. Ms. Liebers advised that she and Ms. Pool preferred the Golz proposal with a minor amendment. They proposed that ALAE be renamed Special Claim Expense (SCE) and that ULAE be renamed General Claim Adjustment Expense (GCAE). They believed that “adjustment” in SACE would be confusing.

Mr. Roth advised that a name would need to be selected at the meeting, as related Blanks proposals would need to be prepared. He asked each task force members to declare their preference. Upon motion by Clark Simcock (D.C.) and second by R. Michael Lamb (Ore.), the task force, by voice vote decided to rename ALAE and ULAE as Defense and Cost Containment (DCC) and Adjusting and Other (AO) respectively.

Joe Pomilia (National Association of Independent Insurers—NAII) noted that there remained several places in the Blank where the term loss adjustment expense was used. He added that this could be confusing to insurers as they report information to the states and the NAIC. Mr. Roth advised that the new terms were a division of loss adjustment expense and as such should not be confusing.

Mr. Roth noted that the information packet prepared for the task force contained two draft letters responding to the questions about the appropriate assignment of certain items to ULAE and ALAE. He asked if the task force agreed with the proposed responses. There were no changes suggested so Mr. Roth directed NAIC staff to distribute the letters (Attachments One through Four).
Generally Accepted Accounting Principles

30. FAS 60 provides the following guidance:

Claim Cost Recognition

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

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4 Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60(d)).
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20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters' fees. Claim adjustment expenses also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.

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5 Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.
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31. The AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies (AICPA P&C Audit and Accounting Guide) provides the following guidance:

Loss Reserves

8.17 Both SAP and GAAP require that insurance companies report a provision for all incurred losses that are unpaid as of the balance sheet date, including losses incurred but not reported. The liability is based on management's estimate of the ultimate cost of settling each loss. The statutes of many states, however, require minimum reserves for certain lines, called excess Schedule P reserves, primarily bodily injury liability and workers' compensation. The minimum reserves are based on the company's actual loss ratio in the five years immediately preceding the most recent three years. The lowest ratios for these years, with a stipulated minimum ratio of 60 percent (65 percent for workers' compensation) and a maximum ratio of 75 percent, are used. The determined ratio is applied to earned premium for each of the three most recent calendar years. The minimum reserves are then compared with the estimated liabilities for each of the three years, and any excess of the minimum over the estimates is reported as a separate liability in the statements prepared under SAP. Any changes in the excess reserves are reported as charges or credits directly to surplus. When financial statements are prepared in accordance with GAAP, the entries are reversed, and the excess reserves are restored to retained earnings.
32. AICPA Statement of Position 92-4, *Auditing Insurance Entities’ Loss Reserves* provides the following guidance:

**Estimating Methods**

2.8 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

2.13 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

2.14 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

**Loss Reserve Ranges**

4.15 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserves should include and analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

33. AICPA Statement of Position 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (SOP 94-5) provides the following guidance:

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 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.
34. The AICPA Audit and Accounting Guide: Health Care Organizations provides the following guidance:

**Accounting for Health Care Costs**

13.02 Health care costs should be accrued as services are rendered, including estimates of the costs of services rendered but not yet reported. Furthermore, if a provider of prepaid health care services is obligated to render services to specific members beyond the premium period due to provisions in the contract or regulatory requirements, the costs of such services to be incurred, net of any related anticipated revenues, also should be accrued currently. Costs that will be incurred after a contract is terminated, such as guaranteed salaries, rent, and depreciation, net of any anticipated revenues, should be accrued when it is determined that a contract with a sponsoring employer or other group will be terminated.

13.03 Amounts payable to hospitals, physicians, or other health care providers under risk-retention, bonus, or similar programs should be accrued during the contract period based on relevant factors, such as experience to date.

13.04 The basis for accruing health care costs and significant business and contractual arrangements with hospitals, physicians, or other associated entities should be disclosed in the notes to the financial statements.

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies, Chapter 11, Unpaid Life Insurance Claims, and Chapter 14, Accident and Health Claims
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 10, Losses, and Chapter 11, Loss Adjustment Expenses
- Accounting Practices and Procedures Manual for Health Maintenance Organizations, Chapter 8, Liabilities
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Minutes of the June 6, 1995 Accounting Practices and Procedures (EX4) Task Force
- Minutes of the September 23, 1997 meeting of the Casualty Actuarial (Technical) Task Force
- Minutes of the June 23, 1998 meeting of the Casualty Actuarial (Technical) Task Force

**Generally Accepted Accounting Principles**
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- AICPA Statement of Position 92-4, *Auditing Insurance Entities’ Loss Reserves*
- AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies
- AICPA Audit and Accounting Guide: Health Care Organizations
- AICPA Statement of Position 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*
State Regulations
- No further guidance obtained from state statutes or regulations

Other Sources of Information
- Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves* (Also published as Appendix 2 to *Actuarial Standard of Practice No. 9, Actuarial Standards Board*)
Statutory Issue Paper No. 56

Universal Life-Type Contracts, Policyholder Dividends, and Coupons

STATUS
Finalized March 16, 1998

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Current statutory accounting guidance for universal life-type contracts, policyholder dividends, and coupons is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts, Chapter 15, Liabilities Related to Policyholder Dividends, Chapter 18, Premium Income, and Chapter 20, Policy and Contract Benefits, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). General reserve requirements and accounting for life contracts has been established in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50) and Issue Paper No. 51 - Life Contracts (Issue Paper No. 51). Current SAP requires liabilities for dividends on participating policies to be established for dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. Unmatured policyholder coupons are recorded at the present value of the unmatured coupons, discounted at interest and mortality.

2. GAAP guidance for universal life-type contracts and coupons requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder and requires all dividends to be accrued based on the results to date, regardless of when due or payable.

3. The purpose of this issue paper is to provide additional guidance on certain unique features and characteristics relating to universal life-type contracts, policyholder dividends, and coupons consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to all universal life-type contracts described in Issue Paper No. 50, all participating contracts, and to all life insurance contracts with coupons. It applies the basic reserving principles relating to life contracts as established in Issue Paper No. 51, prescribes additional accounting requirements regarding unique features of universal life-type contracts, as well as accounting requirements for dividends on participating policies and coupons on life policies.

5. Universal life-type contracts include, among others, flexible premium universal life and fixed premium universal life contracts. Participating contracts include any contract where policyholders are entitled to policy dividends.

6. Premium recognition for fixed premium universal life-type contracts shall be consistent with the accounting requirements of Issue Paper No. 51. Premium on flexible premium universal life-type contracts shall be recorded when received from the policyholder.
Flexible Premium Universal Life-Type Contracts

7. Policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Unlike traditional life insurance contracts, flexible premium universal life-type contracts do not have guaranteed premiums and some assumption as to future premiums is required. Appendix A-585 establishes a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums on flexible premium universal life-type contracts so that traditional valuation methodologies could be used. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium. Appendix A-585 shall be used in establishing reserves for flexible premium universal life-type contracts.

Fixed Premium Universal Life-Type Contracts

8. Policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Fixed premium universal life-type contracts shall also follow the guidance in Appendix A-585. Certain fixed premium products offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value. Appendix A-585 requires secondary guarantees to be considered when establishing policy reserves and shall be followed in establishing reserves for fixed premium universal life-type contracts.

Policyholder Dividend Liability

9. A reporting entity shall accrue, as applicable, the following items relating to participating policies. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following twelve months, and dividends left on deposit to accumulate at interest.

10. Dividends due and unpaid represent dividends payable to the policyholder in the current year but which have not been disbursed or otherwise applied at the reporting date.

11. Dividends payable in the following calendar year represent the estimated amount of all dividends declared by a reporting entity’s board of directors prior to the end of the statement year which are not yet paid or due at the end of the year (dividends apportioned for payment) as well as all dividends payable in the following calendar year that have not been declared (dividends not yet apportioned for payment). For individual insurance the amount of this liability shall be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year.

12. Dividends left on deposit with the reporting entity shall be recorded in the amount of the deposit and accrued interest thereon. At the balance sheet date, the interest accrued but not yet credited to the policyholders’ accounts, shall be established as part of this liability.

Coupons

13. Some entities issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy’s anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures. The liability for unmatured policyholder coupons shall be the face value of the coupon, discounted at interest and mortality.
Disclosures

14. For life and annuity reserves the financial statements shall disclose the following:
   a. A description of reserve practices concerning the following:
      i. Waiver of deduction of deferred fractional premiums upon death of insured;
      ii. Return of portion of final premium for periods beyond the date of death; and
      iii. Amount of any surrender value promised in excess of the reserve as legally computed;
   b. The methods employed in the valuation of substandard policies;
   c. The amount of insurance, if any, for which the gross premiums are less than the net premiums according to the valuation standards;
   d. The method used to determine tabular interest, tabular less actual reserves released, and tabular cost (by formula or from the basic data for such items); and
   e. The nature of significant other reserve changes.

15. Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:
   a. Subject to discretionary withdrawal:
      i. With market value adjustment, where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and;
         (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer;
         (b) In installments over five years or more, with or without a reduction in the interest rate during the installment period;
      ii. At book value less current surrender charge, where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as described in (v.(d)) below;
      iii. At market value, where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk;
   iv. Total with adjustment or at market value;
v. At book value without adjustment (minimal or no charge or adjustment), where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment;

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period;

(c) In a lump sum subject to a fixed surrender charge of less than 5%;

(d) In a lump sum subject to surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues;

(e) All others;

b. Not subject to discretionary withdrawal;

c. Total gross;

d. Reinsurance ceded;

e. Total net.

16. If the reporting entity has reported life insurance premiums and annuity considerations deferred and uncollected on policies in force as of the financial statement date, disclose separately the amounts and the loading excluded for each of the following lines of business:

a. Industrial business;

b. Ordinary new business;

c. Ordinary renewal;

d. Credit life;

e. Group life;

f. Group annuity.

17. Disclose the aggregate amount of direct premiums written through managing general agents or third party administrators. For purposes of this disclosure, a managing general agent means the same as in Appendix A-225. If this amount is equal to or greater than 5% of surplus, provide the following information for each managing general agent and third party administrator:

a. Name and address of managing general agent or third party administrator;

b. Federal Employer Identification Number;

c. Whether such person holds an exclusive contract;

d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. Total premium written.

18. Reporting entities shall disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, the amount of dividends, and the amount of any additional income allocated to participating policyholders in the financial statements.

DISCUSSION

Statutory Guidance

19. The statutory accounting principles outlined in the conclusion above are consistent with current statutory accounting and Issue Paper No. 51.

Flexible Premium Universal Life-Type Contracts

20. As discussed in Issue Paper No. 51, policy reserves are generally established as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Traditional life insurance contracts generally provide a guaranteed set of future cash values and death benefits for a stated premium. Flexible and fixed premium universal life contracts typically develop cash surrender values that are based on a retrospective accumulation of premiums less mortality and expense charges, at a rate of interest declared by the reporting entity or based upon an index. Features such as flexible premiums and variable interest contracts are not compatible with the valuation procedures used for traditional contracts.

21. Flexible premium contracts produce a special valuation problem in that some assumption as to future premiums is required. The method of estimating the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums must be modified to apply to a flexible premium universal life-type contract since neither future premiums nor future benefits are known for a particular policy. The Model UL Regulation established a minimum reserving method for universal life-type contracts by providing guidance on how to estimate future premiums and related benefits on flexible universal life-type contracts so that traditional valuation methodologies could be used.

22. The Model UL Regulation provides a method for calculating reserves for flexible premium universal life contracts as the present value of future guaranteed benefits less the present value of valuation net premiums where the present value of valuation net premiums takes into account an expense allowance, multiplied by a ratio. This ratio is determined at each valuation date as the policyholder account balance divided by the Guaranteed Maturity Fund (GMF), the ratio not to exceed 1. The GMF’s are an accumulation of Guaranteed Maturity Premiums (GMP) which are level gross premiums that provide for endowment at the latest permissible maturity date under the contract. Alternative minimum reserves shall be required, if applicable, for flexible premium universal life-type contracts if the guaranteed maturity premium is less than the valuation net premium, both as defined in the Model UL Regulation.

Fixed Premium Universal Life-Type Contracts

23. Many reporting entities offer products whose cash values are calculated using universal life-type contract accumulation procedures, but which lack complete flexibility in premium payments. These products follow a similar set of valuation rules set forth in Appendix A-585. However, some of these products also offer the policyholder a secondary guarantee. A secondary guarantee provides the policyholder a guaranteed set of cash values, death benefits, and maturity benefits that will be provided regardless of the performance of the policy value.

24. Reserves for these products under Appendix A-585 are determined by computing the excess of the projected present value of future guaranteed benefits, taking into account secondary guarantees, over the present value of the future valuation net premium guaranteed at issue.
Policyholder Dividend Liability

25. Ordinary life and industrial life policies may be issued either on a participating or a nonparticipating plan. Under participating plans, policyholders are entitled to policy dividends that have been declared by the reporting entity’s board of directors. These dividends reflect all or a part of the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the reporting entity based on the terms of the contract.

26. On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the reporting entity to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

27. On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

28. Group life may also be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. See Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts regarding experience rating refunds.

29. A liability shall be established for the estimated dividends that will be paid on participating policies in the next twelve months, whether declared or not (dividends not yet apportioned for payment), since dividends are generally paid in the next policy year. Ordinary life contract dividends should also include those contingent on the payment of renewal premiums (generally first year dividends).

GAAP Guidance

30. In Issue Paper Nos. 50 and 51, the GAAP guidance (principally, FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97), and AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises (SOP 95-1)) related to insurance contracts, including universal life-type and participating contracts, was rejected for the reasons set forth therein.

Drafting Notes/Comments

- SAP literature was not excerpted from Chapters 10 and 18 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies since all such literature is included in Issue Paper 51 which is consistent with this issue paper.
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.
- Issue Paper No. 66 addresses Accounting for Retrospectively Rated Contracts.
- Issue Paper No. 74 addresses Life, Deposit-Type and Accident and Health Reinsurance.
- Issue Paper No. 89 addresses Separate Accounts.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting

31. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to policyholder dividends:

A company may have three liabilities for policyholder dividends. They are dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following calendar year, and dividends left on deposit to accumulate at interest. (Some companies may have an additional dividend liability to provide for amounts provisionally held for payment under deferred dividend policies beyond the following calendar year. Deferred dividend policies, generally prohibited or no longer issued, provide for dividends payable at less frequent intervals than annually.)

Dividends Due and Unpaid

These are dividends payable to the policyholder in the statement year but which have not been disbursed or otherwise applied at the balance sheet date. This may happen when the cash dividend has not yet been disbursed or, to a greater extent, when the premium to which the dividend is to be applied has not been collected and the full premium has been recorded as due and uncollected.

Dividends applied to reduce the premium usually are recorded when the premium is collected. Thus, if a premium is due at the balance sheet date, the premium is recorded as uncollected and a liability for the dividend is established. This may not be the case if the company does all of its bookkeeping for due premiums as if the premium had been collected on the due date. If it does, it would have effectively applied all dividends except those payable in cash.

Some companies pay a first policy year dividend conditional on the payment of the second year premium. Treatment would be similar to that of a dividend used to reduce premium payments.

Dividends Payable in the Following Calendar Year

The estimated amount of all dividends declared by a company’s board of directors prior to the end of the statement year which are not yet paid or due at the end of the year, must be included under the liability “Dividends apportioned for payment” in the annual statement. Since companies may declare dividends to policyholders based on other than calendar year anniversary dates (i.e., July 1 to July 1), it is occasionally necessary to estimate the amount of dividends which may be ultimately paid. Thus, at December 31 of the current year, dividends payable from January 1 to June 30 of the following year would be reported under “Dividends apportioned for payment” and an estimate of dividends payable from July 1 of the following year to December 31 of the following year would be reported under “Dividends not yet apportioned”. In other words, a company must establish a liability for all dividends payable in the following calendar year whether declared or not. In some instances, the board does not declare dividends until after the end of the year at which time the surplus earnings for the statement year will have been determined. The estimated amount of such dividends to be authorized for payment in the calendar year following the statement date must also be included under “Dividends not yet apportioned.”

For individual insurance the amount of this liability should be equal to the aggregate amount of the dividends estimated to be payable in the following calendar year whether or not declared or apportioned. Such dividends should include those contingent on the payment of renewal premiums (generally first year dividends).

For group insurance and pensions, the amount of liability is generally equal to the portion of the dividend payable in the following calendar year which has been earned in the current calendar year. For group pensions the dividend year is generally a calendar year.
Dividend Accumulations

If the policyholder elects to leave the dividend on deposit with the company, the company must record an appropriate liability. This liability is for the amount of the deposit and accrued interest thereon. Interest usually is credited annually on the policy anniversary at the rate stated in the policy or at a rate declared by the company if greater than the stated contract or guaranteed rate. At the balance sheet date, the interest accrued but not yet credited to the policyholders’ accounts, must be established as part of this liability.

Coupons

Some companies issue policies that guarantee an annual return, usually evidenced by a coupon that is part of the policy and matures on the policy’s anniversary. This return represents an annual pure endowment, and is essentially a return of premium previously paid by the policyholder. Some states prohibit or strictly regulate policies with such provisions. To collect the return, in most cases, the policyholder must submit the coupon to the company. If the coupon is not submitted for payment, it should be treated as a deposit (accumulation) and accrue interest at the stated rate.

Coupons may be presented for cash, be used to reduce the premium, or left at interest. If the company permits, a coupon also may be used to purchase paid-up additional insurance.

The liability for unmatured coupons is generally carried as part of the policy reserve or as a separate policy liability. No matter how the liability is presented, it generally is the same as that for a one-year pure endowment policy in the amount of the face value of the coupon.

For matured coupons that have been left to accumulate, the liability is determined in the same way as the liability for dividend accumulations. Interest accrued is calculated for each coupon from the date each matures.

32. The Life/A&H Accounting Practices and Procedures Manual, Chapter 20, Policy and Contract Benefits, provides the following guidance with respect to policy and contract benefits including policyholder dividends:

Other Benefits

Other contract benefits reported in the Summary of Operations are:

1. Coupons, guaranteed annual pure endowments, and similar benefits.

2. Surrender benefits. These are amounts payable on termination of a policy other than by death or maturity. Such surrender benefits, where available, are guaranteed in the policy. The surrender value of additional insurance purchased by application of dividends is included in this item as well as amounts applied to repay any existing policy loan.

3. Interest on policy or contract funds. Included here are incurred interest payments made on deferred benefit payments and interest credited on premium and other deposit funds after deducting the discount allowed on policy proceeds paid in advance. Excluded from this item are interest on supplementary contracts, dividend accumulations and accumulations of coupons, and guaranteed annual pure endowments which do not exceed the annual premium and similar benefits.

4. Payments on supplementary contracts with life contingencies. In addition to the periodic payments incurred this would include the commuted value of any remaining guaranteed payments upon termination of the contract by death or surrender.
5. Payments on supplementary contracts without life contingencies and of dividend accumulations. The commuted value of any remaining payments upon termination of supplementary contracts without life contingencies by death or surrender would also be included.

6. Accumulated coupon payments.

Dividends to Policyholders

Individual life and health insurance policies may be issued either on a participating or a nonparticipating plan. Under the participating plan, policyholders are entitled to policy dividends that have been declared by the company's board of directors. These dividends reflect the difference between the premium charged for a given class of policies and the actual cost of these policies as experienced by the company. Under the nonparticipating plan, policies are written for a premium that is usually lower than the gross premium on participating insurance.

Group life and health insurance pensions also may be issued on a participating or a nonparticipating basis. If the contract is nonparticipating, it may provide for refunds or premium adjustments through a variety of experience rating arrangements. The group contract may state the experience rating formula to be used in the calculation of refund of premium adjustment. If the formula is stated, it will usually provide that the difference of premiums and interest over claims, reduced by applicable contingency reserves and a retention percentage, will be paid to the group contract holder. The retention percentage is based on the amount the company estimated to be necessary for administration costs, contingency reserves, insurance costs (for pooled experience in all similar groups, i.e., to pay some of the claims in other similar groups when these claims exceed the premiums collected for those similar groups), and a margin for profit. If the contract is participating, dividends will be paid in cash to the employer or, on his written request, be used toward the payment of the next premium.

Should dividend adjustments exceed the amounts contributed by an employer in a contributory plan, the excess must be used for the benefit of the employees—refunded to them, used to enable them to skip contributions for a period, or applied to buy additional insurance or benefits.

Dividends distributed to participating policyholders are not profits in a commercial sense; instead, they represent a return of a portion of the gross premium. The portion of the company's earnings before dividends that is not deemed necessary to strengthen surplus or contingency reserves may be distributed among individual policyholders.

The method of calculating dividends is rarely, if ever, stated in the policy. Instead, the policy makes some declaration that, perhaps, may state: "While this policy is in force...the share of the divisible surplus accruing on this policy shall be annually determined by the company and apportioned as a dividend payable on the following policy anniversary. It is not anticipated that a dividend will be payable for at least two years from date of issue." The statutes of various states describe the conditions under which policyholder dividends are to be declared and paid.

Each year the company must determine how much of the total earned surplus (previously existing, plus additions for the year) should be retained as a contingency fund (or as another special surplus appropriation) and how much should be distributed to the policyholders. It is important to note that no fixed relationship may exist between the surplus gain in a particular calendar year and the dividends distributed to the policyholders on the next policy anniversaries. The directors of the company make the decision as a matter of business judgment. The amount earmarked for distribution is designated as divisible surplus and, once set aside by action of the directors, loses its identity as surplus and becomes a liability of the company.

A company having both participating and nonparticipating policies in force usually must make a separate accounting of each class of insurance and include with its annual statement a separate statement of the operations of each class unless an overwhelming proportion of the business in force (90% of more in certain states) is either participating or nonparticipating. Some states limit
the amount of surplus attributable to participating policies that may be transferred to the benefit of the stockholders.

Individual life insurance policies that will participate in the operating gains of the company are almost always sold as such. Occasionally, a company may pay a dividend on a nonparticipating policy or convert it to a participating plan. These situations, however, are very unusual.

Dividends are generally payable on the policy anniversary provided all premiums (annual premiums or installments) have been paid up to that date. The first dividend under a policy is usually paid at the end of the second or third policy year. Occasionally, a dividend is paid at the end of the first policy year on the condition that the annual premium for the second year has been collected.

On ordinary policies, the policyholder generally may choose one of five ways of receiving or using the dividend. If no choice is made, the policy usually states which option is to be automatically used. Dividends may be either (1) paid in cash, (2) applied as a reduction of the next premium, (3) applied to buy paid-up additional insurance, (4) left on deposit with the company to accumulate at a guaranteed rate of interest, or (5) applied to purchase one-year term insurance up to the maximum specified in the agreement (generally the policy cash surrender value) with any balance of the dividend being applied under one of the four other options. Other options may also be available.

On industrial policies, dividends are usually paid as premium credits (applied to pay renewal premiums) or as paid-up additional insurance, as specified in the policy.

Dividends to the policyholders incurred during the period represent the dividends paid or credited, adjusted to include the liabilities at the statement date for dividends due and unpaid, less the corresponding liabilities outstanding at the end of the previous period.

**Generally Accepted Accounting Principles**

33. FAS 60 provides the following guidance related to policyholder dividends (other relevant sections of FAS 60 have been excerpted in Issue Paper No. 51):

Policyholder Dividends

41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.

42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policyholders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and statutory financial statements that will reverse and enter into future calculations of the dividend provision.

43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.
34. SOP 95-1 provides the following guidance on policy reserves for participating contracts issued by mutual life insurance enterprises, fraternal benefit societies and stock life insurance subsidiaries of mutuals or fraternals:

Liability for Future Policy Benefits

15. A liability for future policy benefits relating to participating life insurance contracts should be equal to the sum of --

a. The net level premium reserve for death and endowment policy benefits.

b. The liability for terminal dividends.

c. Any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60.

16. The net level premium reserve should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend fund interest rate is not determinable and there is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above rates exists, then the interest rate used to determine minimum cash surrender values -- as set by the National Association of Insurance Commissioners’ (NAIC) model standard nonforfeiture law--for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

17. Terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:

a. Payment of the dividend is probable.

b. The amount can be reasonably estimated.

4 These conditions should be used in the same sense that they are used in FASB Statement No. 5, Accounting for Contingencies.

If the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of deferred acquisition costs discussed in paragraph 20.)

18. Increases in the liability for future policy benefits should be reported as an expense in the statement of earnings.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 15 and 20
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 120, Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts
- AICPA Statement of Position 95-1, Accounting for Certain Activities of Mutual Life Insurance Enterprises

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 57

Title Insurance

STATUS
Finalized March 16, 1998

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Current statutory guidance for premium revenue recognition, unpaid claims, losses, and loss adjustment expenses for title insurance contracts is contained in Appendix B of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance states that title insurance premiums are fully earned on the date of policy issuance; however, most states require title insurance companies to establish and maintain an unearned premium or reinsurance reserve. This guidance also states that title insurance companies are not required to give recognition to Incurred But Not Reported (IBNR) losses as a liability in statutory reporting; however, disclosure of IBNR is required in Schedule P by the NAIC Annual Statement Instructions - Title (Annual Statement Instructions). Current statutory guidance for title plants is contained in Appendix B of the P & C Accounting Practices and Procedures Manual. This guidance states that title insurers are authorized to invest in title plants and to classify them as admitted assets, subject to certain valuation restrictions.

2. GAAP guidance for premium revenue recognition is found in paragraph 16 of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60). GAAP guidance for claim cost recognition is found in paragraphs 17 through 20 of FAS 60. GAAP guidance for title plants is presented in FASB Statement No. 61, Accounting for Title Plant (FAS 61), as amended by FASB Statement No. 121, Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (FAS 121).

3. The purpose of this issue paper is to establish statutory accounting principles for title insurance that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A variety of services are generally provided (either by the title insurance underwriter, its agent or others) in connection with the transfer of title to real estate. Title insurance rates frequently are determined in the rate making process based on the bundle of services provided, including some or all of title search and examination and closing or escrow fees, referred to as “Gross All-Inclusive” premiums. By statute or custom, certain states exclude title search and examination and closing or escrow fees from the rate-making process for title insurance premiums; referred to as “Gross Risk Rate” premiums. Premiums shall be recorded at the date of policy issuance, on either the Gross All-Inclusive or Gross Risk Rate premium basis, consistent with the rate-making method used. Amounts paid to or retained by agents shall be reported as an expense.

5. A liability shall be established for all known unpaid claims and loss adjustment expenses (known claims reserve), consistent with paragraph 23 of this issue paper, with a corresponding charge to income. The future payments associated with settling known unpaid claims and loss adjustment expenses meet the definition of a liability as established in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).
6. Premium revenue shall be deferred to the extent necessary to maintain a Statutory or Unearned Premium Reserve (SPR/UPR) determined in accordance with the reserve section detailed in paragraph 23 of this issue paper.

7. Additionally, a supplemental reserve shall be established consisting of any other reserves necessary, which when taken in combination with the reserves required by paragraphs 5 and 6 of this issue paper will be sufficient to cover the company’s liabilities with respect to all known claims, IBNR claims, and loss adjustment expenses. The total of the known claims reserve, SPR/UPR, and the supplemental reserve shall not be less than the actuarially determined liability for the sum of known claims, IBNR claims, and loss adjustment expenses or the amount determined in accordance with paragraph 23 of this issue paper.

8. Consistent with the statutory objective of maintaining a SPR/UPR in an amount sufficient to purchase reinsurance, the criteria for revenue recognition in paragraphs 6 and 7 recognize the economics of the title insurance contract over the estimated period of exposure.

9. The actuarially determined liability for the sum of known claims reserve required in paragraph 5, and the IBNR claims and loss adjustment expenses required in paragraph 7 of this issue paper, shall be determined consistently with the guidance detailed in Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55), except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims.

10. Assets acquired in settlement of claims (e.g., mortgages and real estate) shall be accounted for consistent with the guidance related to the asset acquired. For example, an impaired loan shall be accounted for in accordance with Issue Paper No. 37 - Mortgage Loans, and real estate acquired in foreclosure shall be accounted for in accordance with Issue Paper No. 40 - Real Estate Investments.

11. The financial statements or notes thereto shall disclose the following items for each period presented:
   a. The amount of premium revenue reported on the Gross All-Inclusive and on the Gross Risk Rate premium basis;
   b. The amount of the known claims reserve, SPR/UPR, and the supplemental reserve;
   c. Whether the insurer uses discounting in the calculation of its supplemental reserve, the method and rate used to determine the discount, and the amount of such discount.

12. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

**Title Plant**

13. Title plants are an integrated and indexed collection of title records consisting of documents, maps, surveys, or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained. They are tangible assets unique to the title insurance industry, and are the principal productive asset used to generate title insurance revenue and to mitigate the risk of claims. Title plant shall be reported as an admitted asset, subject to the following valuation restrictions:
   a. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the company to conduct title searches and...
issue title insurance policies. The capitalized costs shall be directly related to, and properly identified with, the activities necessary to construct the title plant.

b. Purchased title plants, including a purchased undivided interest in a title plant, shall be recorded at cost at the date of acquisition. For a title plant acquired separately, cost shall be measured by the fair market value of the consideration given. For title plant acquired as part of a group of assets, cost shall be measured by the fair value of the consideration given and then cost shall be allocated to the title plant based on its fair value in relation to the total fair value of the group of assets acquired. For title plants acquired as part of a purchase of assets or in a business combination, cost shall be determined in accordance with Issue Paper No. 68 - Business Combinations and Goodwill.

c. After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant that antedates the period of time covered by the existing title plant (backplant). Costs to construct a backplant must be properly identifiable to qualify for capitalization.

d. Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another; or (b) modify or modernize the storage and retrieval system shall not be capitalized.

e. Costs incurred to maintain a title plant shall be expensed as incurred.

f. Costs incurred to perform title searches shall be expensed as incurred.

g. The aggregate carrying value of an investment in a title plant or plants shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders.

14. Certain circumstances may indicate that the value of the title plant may be impaired and, thus, the carrying value of the asset may not be recoverable. If there is an indication of possible impairment of value, the title plant shall be evaluated for impairment and recorded in accordance with Issue Paper No. 5. The following are examples of circumstances that may indicate impairment:

a. effects of obsolescence, demand and other economic factors;

b. a significant change in the legal or business climate in the jurisdiction for which the title plant is established and maintained;

c. a current period operating or cash flow loss combined with a history of such losses or projections that indicate continued losses associated with the revenue produced by the title plant;

d. a lack of appropriate maintenance to keep the title plant up to date;

e. abandonment of a title plant.

15. A properly maintained title plant has an indeterminate life and does not diminish in value with the passage of time, and accordingly, shall not be depreciated.

16. A title insurer may (a) sell its title plant and relinquish all rights to its future use; (b) sell an undivided ownership interest in its title plant; or (c) sell a copy of its title plant or the right to use it. Accounting and presentation for each type of sale noted shall be as follows:
a. When a title insurer sells its title plant and relinquishes all rights to its future use, consideration received shall be presented as a separate component of revenue net of the carrying value of the title plant sold.

b. When a title insurer sells an undivided ownership interest in its title plant, consideration received shall be presented as a separate component of revenue net of the pro rata portion of the carrying value of the title plant.

c. When a title insurer sells a copy of its title plant or the right to use it, consideration received shall be presented as a separate component of revenue and the carrying value of the title plant shall not be reduced.

DISCUSSION

17. The P & C Accounting Practices and Procedures Manual states that title insurance premiums are fully earned on the date of policy issuance; however, title insurance companies are required to establish and maintain an unearned premium or reinsurance reserve. The primary objective of the SPR/UPR is to maintain at all times a reserve amount which is sufficient to purchase reinsurance for the IBNR claims and related loss adjustment expenses. Consistent with this objective, the statutory principles in paragraph 6 of this issue paper retain current statutory guidance, which requires that changes in the amount of the SPR/UPR be reflected as an adjustment to premium revenue. Additionally, the supplemental reserve required in paragraph 7 of this issue paper is analogous to the concept of a premium deficiency reserve as discussed in Issue Paper No. 53 - Property and Casualty Contracts - Premiums (Issue Paper No. 53). Consistent with Issue Paper No. 53, anticipated investment income may be used as a factor in the supplemental reserve calculation.

18. The conclusions reached in this issue paper are consistent with current statutory guidance except as follows with the exception that this issue paper requires consideration of IBNR claims and related loss adjustment expenses in evaluating the sufficiency of the SPR/UPR in order to conform with the Title Insurers Model Act. The Model Act requires the reporting entity’s state of domicile to determine the appropriate unearned premium reserve to be set aside. This issue paper also requires the unearned premium reserve to be determined by the reporting entity’s state of domicile. The determination by the state of domicile of this reserve is considered necessary given the nature of this product. This issue paper also requires that the liability for known claims reserves be calculated in accordance with Issue Paper No. 55, except that anticipated salvage and subrogation shall not be deducted from the liability for unpaid claims. Issue Paper No. 55 permits, but does not require, anticipated salvage and subrogation recoverables to be deducted from the liability for unpaid claims; whereas current statutory guidance for title insurers does not permit case basis loss and loss adjustment expense reserves to be reduced for anticipated salvage and subrogation.

19. This issue paper modifies current statutory accounting for title plant to require the evaluation and write-off of impairment in value. This is consistent with Issue Paper No. 5. This issue paper adopts FAS 61, modified for carrying value restrictions, as amended by paragraph 29 of FASB Statement No. 121 - Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (FAS 121). Restrictions on the total carrying value of an investment in a title plant or plants have been set consistent with current statutory accounting outlined in the Title Insurers Model Act. FAS 121 is addressed in Issue Paper No. 40 - Real Estate Investments.

20. The conclusions above reject FAS 60; however, it is considered appropriate to use the factors to be considered in the determination of the ultimate cost of settling claims included in FAS 60 when establishing the reserves in accordance with paragraphs 5 and 7 of this issue paper. The concepts adopted above are consistent with GAAP literature except that GAAP requires immediate revenue recognition for title insurance contracts and the accrual of claims costs at the time title insurance premiums are
recognized as revenue; whereas this issue paper requires that revenues be recognized consistent with the concepts discussed in paragraph 16.

21. The conclusions above are consistent with the regulatory objectives discussed in paragraph 17 of this issue paper and the concept of conservatism in the Statement of Concepts. The conclusions above are also consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

Conservatism

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

Recognition

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to owners.

Consistency

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

Drafting Notes/Comments

- Segregated funds held for others (i.e., escrow funds) will be addressed in Issue Paper No. 77 - Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures.
- Review of state statutes of not less than 38 states indicates the use of a SPR/UPR, we are not aware of any states without such a requirement.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. Amended guidance for title insurance was adopted by the Accounting Practices and Procedures (EX4) Task Force at its October 1, 1996 meeting.
TITLE INSURANCE ACCOUNTING PRINCIPLES SUPPLEMENT

INTRODUCTION

Title insurance insures up to the date of policy issuance that the insured has title to the insured property on a certain title estate, subject to exceptions and exclusions in the policy. Also, a title policy, when issued, has a one-time charge to the insured under the policy and reserves are set aside by the title insurance company that issues said policy.

The business of title insurance differs from that of property and casualty insurance in that its basic goal is risk elimination and not loss reimbursement. This risk elimination function results in significantly lower losses than that of other lines of insurance. Because of this fact, the title insurance business is organized and functions differently and its accounting for revenues, losses and loss adjustment expenses, unearned premium reserves, title plants, and escrow funds differs.

This supplement is intended to present the most commonly used practices and procedures as to those differences. Otherwise, title insurance accounting is in agreement with those described elsewhere in this manual.

Title insurers perform many services in connection with the transfer of real estate; however, their principal function involves insuring, guaranteeing, or indemnifying owners of real property or the holders of liens or encumbrances thereon against loss or damage suffered by reason of defective titles, liens or encumbrances or, in most states, the unmarketability of the title.

A one-time nonrefundable charge is due on the effective date of the insurance. This is described in more detail in the section on title insurance revenue. The term of the policy is indefinite in that the policyholder is insured for as long as he or his heirs or devisees have an interest in the property.

Before a title insurance policy is issued, skilled personnel must search and examine a variety of public records concerning the ownership, liens, and encumbrances on the subject real estate together with information relating to persons having an interest in the real property as well as maps and other records to determine that title to the property is insurable, or defects can be overcome.

In addition to insuring against defective records or examination of those records, an insurer insures against "non-record defects" such as:

- Forgeries
- Fraud
- Confusion of name in change of title
- Incompetency (minor or persons of unsound mind)
- Mistakes in public records
- Undisclosed or missing heirs
- Instruments executed under a fabricated or expired power of attorney
- Deeds delivered after death of grantor or grantee or without the consent of the grantor
- Deeds by persons supposedly single but actually married
- Wills not probated
- Liens against property (mechanic's liens, tax liens, etc.)
- Falsified records

TITLE PLANTS

Title plants are an integrated and indexed collection of title records covering parcels of real estate within a county. They are tangible assets unique to the title insurance industry and are the principal productive asset used to generate title insurance revenue.
A title plant consists of (a) indexed and catalogued information for a period of time concerning the ownership of, and the encumbrance on, real estate, (b) information relating to persons having an interest in real property, (c) maps, plats, and so forth, (d) copies of prior title insurance policies and reports, and (e) other documents and records. In summary, a title plant constitutes a historical record of matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and management decisions concerning the minimum information period needed to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by the addition of copies of documents on the status of title to specific parcels of real estate.

Authorization and Limitations

Title insurers are authorized to invest in title plants and to classify them as admitted assets in their financial statements subject to valuation restrictions which vary from state to state. Insurers’ investments in title plants are detailed in Schedule “H” of the annual statement.

Valuation

Costs incurred to construct a title plant, including the costs incurred to obtain, organize and summarize historical information in an efficient and useful manner, should be capitalized until the title plant can be used by the company to conduct title searches and issue title insurance policies. The capitalized costs should be directly related to, and properly identified with, the activities necessary to construct the title plant.

After the construction or purchase of a title plant, a company may decide to purchase or construct a title plant (backplant) that antedates the period of time covered by the existing title plant. Costs to construct a backplant must be properly identifiable to qualify for capitalization.

Purchased title plants, including a purchased undivided interest in a title plant, should be recorded at cost at the date of acquisition. For a title plant acquired separately, cost should be measured by the fair market value of the consideration given. Title plants purchased as part of a group of assets or as part of a business combination accounted for as a purchase, should be accounted for in accordance with APB Opinion 16, “Business Combinations.”

Costs incurred after a title plant is operational to (a) convert the information from one storage and retrieval system to another or (b) modify or modernize the storage and retrieval system should not be added to the carrying amount of the title plant. Such costs may be capitalized separately as Title Plant Improvements and charged to expense in a systematic and rational manner in accordance with Statement of Financial Accounting Standards No. 61, “Accounting for Title Plant.”

Ordinarily, a title plant has an indeterminate life and does not diminish in value with the passage of time and accordingly should not be depreciated. However, in certain circumstances, evidence may exist that the value of a title plant has been impaired. Evidence of impairment includes the following:

- a change in legal requirements or statutory practices,
- effects of obsolescence, demand, and other economic factors,
- actions of competitors and others that may affect competitive advantages,
- failure to maintain the title plant properly on a current basis, or,
- abandonment of a title plant or other circumstances that indicate obsolescence.

If such evidence exists, title plant values should be adjusted to the lower of carrying value or current fair values in accordance with Statement of Financial Accounting Standards No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.”
Maintenance of Title Plant

Costs incurred to maintain a title plant should be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily basis or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents such as records relating to security or other ownership interests.

Cost of Title Searches

Costs incurred to perform title searches should be expensed as incurred. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.

Sale of Title Plant

A title insurance company may (a) sell its title plant and relinquish all rights to its future use, (b) sell an undivided ownership interest in its title plant, that is, the right to its joint use, or (c) sell a copy of its title plant or the right to use it. If the company sells its title plant and relinquishes all future rights to its use, the amount received as consideration for the sale should be presented as a separate component of revenue, net of the carrying amount of the title plant. If the company sells an undivided ownership interest in its title plant, the amount received as consideration should be presented as a separate component of revenue, net of the pro rata portion of the carrying amount of the title plant. If the company sells a copy of its title plant or the right to use it, the amount received should be presented as a separate component of revenue. Ordinarily no cost should be allocated to the sale of a copy or the right to use a title plant.

STATUTORY PREMIUM RESERVE

The premium related to a title insurance policy is due upon the effective date of the insurance and is not refundable. The term of a title insurance policy is indefinite in that the policyholder is insured for as long as he or his heirs or devisees have an interest in the property. Since title insurance premiums are fully earned on the date of policy issuance, there are no unearned premiums for title insurers.

Most states require title insurance companies to establish and maintain a statutory premium reserve. Generally, the title insurance company must establish this statutorily required deferred income account based upon the law of its domiciliary state. The computation is based upon either premium revenue, number of policies issued, liability assumed, or combinations thereof. The reserve is drawn down in accordance with recovery or amortization formulas as prescribed by state law.

Generally, title insurance companies are required to hold, maintain and segregate investments in marketable admitted assets of a particular type and quality as prescribed by certain states’ statutes in an amount at least equal to the statutory premium reserve. When applicable, such assets are summarized by investment type in a footnote to the “Assets” page of the annual statement.

TITLE INSURANCE REVENUE

The variety of services performed by a title insurance company in connection with the insurance of a real estate title may vary substantially according to local statutes, regulations or practices. This causes a substantial variance in the classification of these services on financial statements of title insurers. While all such services are an integral part of the transfer of title to real estate, services may in some markets be performed by title insurance companies, separately in competition with title insurance agents, or insurers may subcontract some functions to agents or others.
Where title insurance companies perform these services, it is often not possible to allocate specific revenue or costs to a separate function such as search, examination, closing, or escrow services with any precision. Many joint costs of the insurer cannot be adequately allocated to a specific function, and some functional elements of title insurance costs tend to overlap into other areas, e.g., a portion of search and escrow costs performed by a title insurance company could be partially allocated to an underwriting function.

In order to provide for consistency in reporting financial data in the annual statement, all title insurers must strictly follow the guidelines stated in this instruction. The NAIC has dictated that title insurance revenues reported in the annual statement be differentiated as to (1) two generally acceptable premium rate types, and (2) the distribution network for direct premiums written.

However, the NAIC has recognized that the data reported in Schedule “T” of the annual statement is not intended to be used for the calculation of the amount of premium tax due. In the event the basis used for the calculation of premium tax differs from the basis required for reporting in the annual statement, the company should submit to the respective state insurance department or other premium tax collection agency a separate schedule to support its premium tax calculation.

For the purpose of reporting in Schedule “T” and other schedules or exhibits in the annual statement, the amount of title insurance premiums to be reported by premium rate type shall be guided by the following definitions of the methods of reporting "Direct Premiums Written":

1. **Gross All-Inclusive Premiums** - Under this method of reporting direct premiums written, the title insurer and its title agent generally perform all the functions necessary to insure the risk and to issue a title insurance policy. The title insurer reports 100% of the premiums charged either through its branch office or its title agents. Direct premiums written reported under this method generally contemplates some or all of the following factors in the rate-making process:
   a. Cost of title search and examination
   b. Policy issuing cost
   c. Amount retained by agents/abstractors/attorneys
   d. Overhead and miscellaneous expenses
   e. Expected losses and LAE from underwriting the risk
   f. Profit margin.
   g. Additional activities (such as closing) may also be included in specific states.

2. **Gross Risk Rate Premiums** - This method of reporting direct premiums written generally applies to states where either by statute or custom the charge for title search and examination are excluded or charged for separately from the title insurance premiums. The cost factors contemplated in the rate-making process include the proportionate share of all of the factors listed in the "Gross All-Inclusive Premiums" except for the "Cost of the title search and examination."

The applicable premium rate type in effect for each state (either gross all-inclusive or gross risk rate) is reported in the “Premium Rate” column of Schedule “T.”

Generally, the direct premiums written reported in the annual statement should fall within the definitions of either Gross All-Inclusive Premiums or Gross Risk Rate Premiums. The net risk or net remittance method is not an acceptable method of reporting premiums written. In the event the company uses another method, this method must be designated as “Other” in the “Premium Rate” column of Schedule “T” for each state and must be footnoted to define the basis for varying from either the Gross All-Inclusive or Gross Risk Rate method.

In addition to designating the premium rate type in effect for each state for direct premiums written in Schedule “T,” title insurance companies must report direct premiums written by the distribution network within each state. The NAIC has designated three distribution networks, with
direct premiums written reported in separate columns of Schedule “T,” as well as in other schedules or exhibits of the annual statement, as follows:

1. **Direct Operations** - Includes direct premiums written at home office and branch office operations of the title insurer. No amounts attributable to agency operations (even wholly owned agencies) are to be included in this category.

2. **Non-affiliated Agency Operations** - Includes direct premiums written by non-affiliated agency operations. The standard for reporting as a non-affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.

3. **Affiliated Agency Operations** - Includes direct premiums written by affiliated agency operations, including wholly-owned agencies. The standard for reporting as an affiliated agency is the affiliation standard established under the holding company laws of the domestic state jurisdiction.

Revenues received for services performed by a title insurance company, other than premium, are to be reported under the "Other Income" category of Schedule "T."

**EXPENSES**

In the title insurance industry, there are expenses incurred in establishing and maintaining the distribution networks involved in acquiring and underwriting policies and servicing policyholders and third party claimants. Expenses are important elements of the company’s operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC Examiners Handbook - Volume 1.

**Expense Group Classifications**

Expenses for title insurance companies are listed in the “Operations and Investment Exhibit, Part 4, Expenses” of the annual statement. Expenses are specifically identified or allocated and reported for the following groups:

1. **Title and Escrow Operating Expenses** - Title and escrow operating expenses consist of all expenses incurred in relation to engaging in the business of title insurance, including costs associated with the following: issuing or offering to issue a title insurance policy; soliciting or negotiating the issuance of a title insurance policy; guaranteeing, warranting or otherwise insuring the correctness of title searches affecting title to real property; handling of escrows, settlements or closings; executing title insurance policies; effecting contracts of reinsurance and abstracting, searching or examining titles. Also included are specifically identifiable and allocated expenses relating to the following activities: supervision and training of employees and agents; operating costs for branch offices or agencies; underwriting activities; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory and executive duties; postage and delivery; and all other functions reasonably associated with the business of title insurance. Title and escrow operating expenses do not include losses, loss adjustment expenses (allocated or unallocated), expense of other operations or investment expenses. The expenses include only amounts incurred directly by the company, and do not include expenses incurred by any agents (regardless of ownership interest).

2. **Unallocated Loss Adjustment Expenses** - Unallocated loss adjustment expenses ("ULAE") are those indirect costs incurred by a title insurer, typically internal to the company, which are necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis. ULAE should include all costs of outside parties involved in claims adjusting services, but should not include any costs incurred by agents in settlement of title or other claims.
3. **Other Operations** - The amounts shown for this category represent the expenses incurred by the company in operations other than title and escrow, loss adjustment or investment activities.

4. **Investment Expenses** - Investment expenses are those expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

A company that pays management fees to an affiliate shall allocate these costs to the appropriate expense classification item (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management or similar fees should not be reported as a one-line expense. It is appropriate for the company to estimate these expense allocations based on a formula or other reasonable basis.

Title and Escrow Operating Expenses are further broken down in the annual statement by the distribution network that gives rise to the expense incurrence. Accordingly, expenses are specifically identified or allocated (in accordance with reasonable allocation procedures consistently applied) to either Direct Operations, Non-affiliated Agency Operations or Affiliated Agency Operations. Some general guidelines for allocating these expenses to the appropriate distribution network are shown in the following table. The expense classification item (salaries, rent, postage, etc.) are those in the annual statement.

### TABLE 1

**General Guidelines for Classifying Expenses**

<table>
<thead>
<tr>
<th>Expenses to be Allocated to Distribution Network</th>
<th>Principal Basis for Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel costs:</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>Studies of employee activities</td>
</tr>
<tr>
<td>Employee relations and welfare</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Other personnel costs</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Amounts paid to or retained by title agents</td>
<td>Direct charge to non-affiliated or affiliated agents</td>
</tr>
<tr>
<td>Production services (purchased outside)</td>
<td>Study of company practices</td>
</tr>
<tr>
<td>Advertising</td>
<td>Pro rate on basis of Part 2A revenue distribution</td>
</tr>
<tr>
<td>Boards, bureaus and associations</td>
<td>Pro rate on basis of Part 2A revenue distribution</td>
</tr>
<tr>
<td>Title plant rent and maintenance</td>
<td>Study of company practices</td>
</tr>
<tr>
<td>Amounts charged off, net of recoveries</td>
<td>Direct charge by source of business</td>
</tr>
<tr>
<td>Marketing and promotional expenses</td>
<td>Pro rate on basis of Part 2A revenue distribution</td>
</tr>
</tbody>
</table>
Insurance       Pro rate on salary ratios
Directors’ fees       Pro rate on salary ratios
Travel and travel items      Study of company practices
Rent and rent items       Pro rate on salary ratios
Equipment       Pro rate on salary ratios
Printing, stationery, books and periodicals       Pro rate on salary ratios
Postage, telephone, messengers and express       Pro rate on salary ratios
Legal and auditing      Study of company practices
Taxes, licenses and fees      Study of company practices

Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or revenue distribution basis.

NOTES:

Claim adjustment services are all attributable to the Unallocated Loss Adjustment Expenses group.

Real estate expenses and real estate taxes are all attributable to the Investment Expenses group.

Expenses should be specifically identified or allocated to the Unallocated Loss Adjustment Expenses group or Other Operations group based on a study of company practices and employee activities.

AMOUNTS PAID TO OR RETAINED BY TITLE AGENTS

Unlike agents representing other lines of insurance whose primary function is to sell the policy and receive a sales commission, title insurance agents also perform various functions in connection with the issuance of a title insurance policy. These functions can include search and examination, abstracting, certain underwriting and closing services. Typically, the agent collects the entire charge for the title insurance transaction, retains a portion for his services, and forwards the insurer’s portion in accordance with individual agency contracts.

LOSSES AND LOSS ADJUSTMENT EXPENSES/RESERVES

Unlike most other forms of insurance, losses do not generally represent the largest liability or expense for title insurance companies. The emphasis is upon loss prevention and the duty to defend, rather than on reimbursement of losses. Therefore, title insurance companies incur large expenses in labor, equipment, etc. in maintaining title records and in searching and examining the titles to real estate and in curing defects found prior to the issuance of the policy and closing or escrow services.

The liability for unpaid losses is composed of (1) the loss reserve, net of recoveries, for undetermined title and other losses of which notice has been received (known claims reserve), (2) the statutory premium reserve, and (3) the excess of Schedule “P” reserves over statutory reserves (supplemental reserve).
**Definitions**

**Allocated Loss Adjustment Expenses**

Allocated loss adjustment expenses are those expenses that can be related to specific claims and include fees, salaries, overhead and expenses of lawyers for legal service in defense, trial or appeal of suit, other legal services rendered in connection with title claims, and general court costs and fees together with appeal costs and expenses. Allocated loss adjustment expenses should include all costs associated with attorneys involved in litigation of specific claims whether such attorneys are engaged as outside counsel or salaried employees of an insurer. The inclusion of “salaried employees” in the definition of allocated loss adjustment expenses is effective January 1, 1996. Allocated loss adjustment expenses also include any fee or expense, other than claim adjuster services, which is directly attributable to the defense of a particular claim. See definition of Unallocated Loss Adjustment Expenses below.

**Incurred But Not Reported Reserve**

The incurred but not reported reserve (“IBNR”) is an amount estimated to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has not received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. Title insurance companies are not required to give recognition to IBNR losses in statutory reporting unless a “supplemental reserve” is required. See the definition of Supplemental Reserve below.

**Known Claims Reserve**

The known claims reserve (referred to as the “loss reserve for undetermined title and other losses of which notice has been received”) is the amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor. The known claims reserve also includes “bulk” reserves, if any - a provision for subsequent development on known claims.

**Statutory Premium Reserve**

See the “Statutory Premium Reserve” section above. The Statutory Premium Reserve (“SPR”) is considered a liquidation reserve and is equivalent to a property and casualty company’s IBNR reserve. Certain states’ statutes also require insurance companies to segregate investments in an amount at least equal to the SPR. If a title insurer becomes insolvent, the segregated assets are used to pay future claims or purchase reinsurance to settle future claims. In addition, the SPR is intended to provide a reserve for unallocated loss adjustment expenses on all claims.

**Supplemental Reserve**

The supplemental reserve is the excess of Schedule “P” reserves over statutory reserves (i.e., the excess of the known claims reserve + IBNR reserve + ULAE reserve [total Schedule “P” reserves] over the known claims reserve + SPR [statutory reserves]). The supplemental reserve requirement is effective January 1, 1996. Also see “Actuarial Opinion” below.

**Title Insurance Losses**

Title insurance losses should include all losses on any transaction for which a title insurance premium, rate or charge was made or contemplated. Escrow losses for which the company is
contractually obligated should be included. Losses arising from defalcations for which the company is contractually obligated should also be included.

Unallocated Loss Adjustment Expenses

Unallocated loss adjustment expenses ("ULAE") are those expenses other than allocated loss adjustment expenses that are assigned to the expense group "loss adjustment expenses" (i.e. all other expenses, typically internal, necessary to process claims or manage the claims settlement function and which are not incurred on a claim-specific basis). ULAE should include all costs of outside parties involved in claims adjusting services. Schedule “P” reserves include an Unallocated Loss Expense Unpaid component, a reserve estimated to cover all unpaid unallocated loss adjustment expenses on all claims and losses provided for in the known claims reserve and the IBNR reserve. As noted above, the SPR is intended to provide a balance sheet reserve for ULAE on all claims. The requirement to separately report ULAE in the Operating and Investment Exhibit (Part 4 - Expenses) and the ULAE reserve in Schedule “P” is effective January 1, 1996.

Loss Reserving Requirements

Valuation

A company is required to determine what the value of its claims will be when they are ultimately settled, including inflation. Therefore, in general, loss and loss adjustment expense reserves are to be presented on a non-discounted basis. Also see “Loss Reserve Discounting” below.

Known Claims Reserves

The reserve for known claims is generally determined using established reasonable baseline reserves developed by tracking and analyzing historical claims data. These estimates are reviewed and adjusted as necessary.

Incurred But Not Reported Losses and Unallocated Loss Expense Unpaid

In addition to reserving for known claims, a title insurance company must also provide a liability for losses that are incurred but not reported and for unpaid ULAE in Schedule “P,” effective January 1, 1996. Various methods are used for estimating these reserves. Whatever methods are selected for establishing unpaid losses, the goal should always be reserve adequacy. Also see “Actuarial Opinion” below.

Loss Reserve Discounting

Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which the annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected in an insurer’s balance sheet liabilities as included in the annual statement, then the insurer must complete a reconciliation of the discounted liability to the whole dollar value of the reserves in Schedule “P.” The insurer should also complete a note to the annual statement - Discounting of Unpaid Losses or Unpaid Loss Adjustment Expenses - as required by the annual statement instructions.

Actuarial Opinion

Effective January 1, 1996, the Schedule “P” reserves must be supported by an actuarial opinion from a qualified actuary who is a member in good standing of the American Academy of Actuaries, setting forth an opinion as to the adequacy of all loss reserves (known claims reserve, including bulk reserves (if any), + IBNR reserve + ULAE reserve).
Supplemental Reserve Computation - Schedule “P”

As noted above, the supplemental reserve, if any, is the excess of Schedule “P” reserves over statutory reserves. If a supplemental reserve is required, it shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999; and, one hundred percent (100%) thereafter.

Recoveries from Salvage and Subrogation

Salvage and subrogation should be reflected using the following rules:

1. Paid losses must be reported net of realized, but not anticipated, salvage and subrogation. Case basis loss and loss adjustment expense reserves must not be reduced on account of anticipated salvage and subrogation.

2. Paid salvage and subrogation is not realized until a salvage asset or an actual payment pursuant to a subrogation right is in the direct control of the insurer and is admissible as an asset for statutory reporting purposes in its own right.

3. Salvage assets and payments pursuant to a subrogation right are to be booked at current market value. Current market value of real estate is to be established through an appraisal conducted by a qualified independent appraiser.

4. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount less than the value at which it was originally placed on the books of the insurer, then the loss on disposition is to be treated as a decrease in paid salvage (same effect as an addition to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a loss on disposition or change in value of an asset, and is not to be deducted from the salvage on the corresponding claim.

5. If a salvage asset is sold or revalued by the insurer within twelve months of realization for an amount greater than the value at which it was originally placed on the books of the insurer, then the gain on disposition is to be treated as an increase in paid salvage (same effect as a deduction to the paid loss) on the corresponding claim. After twelve months, such salvage revaluation will be treated as a gain on disposition or change in value of an asset, and is not to be added to the salvage on the corresponding claim.

6. IBNR reserves may make a provision for the expected value of future salvage and subrogation on open claims and IBNR claims. This provision must be actuarially determined and should not be based upon current case estimates.

TITLE REINSURANCE

Reinsurance is a contract whereby the reinsurer, for consideration received, agrees to indemnify the ceder or policy-issuing company in whole or in part against loss or liability which the ceder may sustain or incur under a separate and original contract of insurance ("policy") with the original insured owner, lender or lessee. The ceder or ceding company is the company which writes the policy insuring the owner, lender or lessee and cedes, lays off, or transfers to the reinsurer all or a portion of its policy risk or exposure which the reinsurer assumes or acquires under the reinsurance agreement or contract.

The principal functions of reinsurance are to provide insurers with capacity enabling them to write policies in larger amounts than could otherwise be written; to spread the risk of a potential loss in order to protect the insured’s interest on very large transactions; and to protect the policy issuing company from insolvency in the event of a catastrophic loss.
Reinsurance is necessary when a title insurance company is limited to a certain amount of liability on a policy or transaction risk by either the insurer's self-imposed limitation, statutory limitation or the insured's limitation. Each title insurer internally sets a self-imposed limit where reinsurance is obtained when a policy is issued above that limit. Many states have limitations as to qualifications of insurers relating to single risk liability on risks issued on property in that state. In addition, the insureds on a title policy may also have restrictive liability limits pursuant to their own detailed analysis of a title insurer's financial strength and ability to pay a claim. These limitations are sometimes lower or more restrictive than state statutory limits or a title insurer's self-imposed limits. Therefore, on a certain risk which has all three types of limitations present, whichever limitation is lowest will determine how much reinsurance is necessary on a particular transaction. When reinsurance is purchased, the ceding company may reduce its net retained liability for the risk ceded. The reinsuring company would then be responsible for the appropriate reserves pertaining to its assumed liability or premium, subject to applicable rules and regulations of the state where the insured property is located.

Title insurance utilizes two main types of reinsurance. The most common type is facultative reinsurance that pertains to one individual, particular risk or transaction. The ceder may offer all or any part of a risk to one or more other title insurers or reinsurers who may either accept or reject that particular risk. The facultative reinsurance agreements utilized in the title industry have been developed by the American Land Title Association. The most common form utilized today is the 1994 ALTA Facultative Reinsurance Agreement. This agreement contains conditions and stipulations regarding ceder's cession and warranty, reinsurer's assumption, direct access, notices, investigation and settlement of claims, payment of losses, insolvency of ceder, recoupment and subrogation, rights of insured not prejudiced, laws applicable, actions by or on behalf of ceder, severability, notices-where sent and effective date.

Facultative reinsurance allows some flexibility in the spreading of the risk in which the ceder normally retains the primary risk and a share of the secondary level risk, which secondary level is structured on a coordinate and proportionate share among the secondary participants. There may also be other levels of reinsurance which are mainly utilized to induce reinsurers to accept more liability on larger than usual risks. These levels are called the tertiary, quaternary and quinary levels and they are each coordinate and proportionate as to each level. In other words, a reinsurer's secondary share is based on that reinsurer's secondary liability assumption divided by the total amount of secondary allocation of liability. If the ceding company retained a $5,000,000 primary, then they are responsible for 100% of the first level or primary retention retained. If the loss exceeds the primary into the secondary level, then the reinsurers as well as the ceder must pay off per their coordinate and proportionate share of that level until the secondary level is exhausted. If there is a tertiary level, the coordinate and proportionate tertiary percentage shares as to the total tertiary level control the payment of loss. And so on as to each level of liability.

The other type of reinsurance utilized in the title industry is called treaty reinsurance. This is mainly utilized by smaller companies that have a much smaller self-imposed or statutory limit and do not have the personnel to handle individual facultative agreements on each policy written over their threshold liability limit. This is usually done on an excess of loss basis where a treaty contract is negotiated where ceder is indemnified against loss in excess of a specified retention, normally subject to a specified limit, with respect to each risk covered by the treaty. Normally, the treaty contract specifies contingencies in the event the risk is greater than the treaty contract terms and therefore not covered under the treaty. Either the ceder may have to purchase facultative reinsurance, or the treaty reinsurer would assume all liability under the risk subject to the treaty ceder’s primary retention and purchase its own facultative reinsurance on the liability in excess of the treaty limitations.

Schedule “F” of the annual statement summarizes relevant information for both assumed and ceded reinsurance.
SEGREGATED FUNDS HELD FOR OTHERS

Title insurers provide services in which they have custody and are accountable for cash and other assets belonging to others. Generally these services relate to real estate settlement services in which closing "escrow" funds are received and disbursed and note and contract collection services in which payments of principal and interest are received and disbursed. In addition, title insurers may hold cash or other assets as security for indemnity agreements with the company and others relating to title matters.

These "custodial" funds are set apart in special accounts and are excluded from title insurer's assets and liabilities in the statutory statement. However, the title insurer's accountability for these "custodial" funds is reported in a footnote and the detail of segregated deposits of these funds in banks, trust companies, and savings and loan associations are reported in Schedule "E" of the annual statement.

23. The Title Insurers Model Act was adopted by the Title Insurance Working Group of the Special Insurance Issues (E) Committee on December 4, 1995 and was adopted by the full membership of the NAIC at the March, 1996 Plenary Session (only the pertinent excerpts are included below):

Section 3. Definitions

W. "Title Plant" means a set of records consisting of documents, maps, surveys or entries affecting title to real property or any interest in or encumbrance on the property, which have been filed or recorded in the jurisdiction for which the title plant is established or maintained.

Section 9. Admitted Asset Standards

In determining the financial condition of a title insurer doing business under this Act, the general investment provisions of [insert reference to applicable provision of the insurance code governing investments] shall apply, except that an investment in a title plant or plants in an amount equal to the actual cost shall be allowed as an admitted asset for title insurers. The aggregate amount of the investment shall not exceed the lesser of twenty percent (20%) of admitted assets or forty percent (40%) of surplus to policyholders, as shown on the most recent annual statement of the title insurer on file with the commissioner.

Section 10. Reserves

In determining the financial condition of a title insurer doing business under this Act, the general provisions of the insurance code requiring the establishment of reserves sufficient to cover all known and unknown liabilities including allocated and unallocated loss adjustment expense, shall apply, except that a title insurer shall establish and maintain:

A. A known claim reserve in an amount estimated to be sufficient to cover all unpaid losses, claims and allocated loss adjustment expenses arising under title insurance policies, guaranteed certificates of title, guaranteed searches and guaranteed abstracts of title, and all unpaid losses, claims and allocated loss adjustment expenses for which the title insurer may be liable, and for which the insurer has received notice by or on behalf of the insured, holder of a guarantee or escrow or security depositor.

B. A Statutory or Unearned Premium Reserve consisting of:

(1) The amount of statutory or unearned premium reserve required by the laws of the domiciliary state of the insurer if the insurer is a foreign or non-U.S. title insurer; or

(2) If the insurer is a domestic insurer of this state, a statutory or unearned premium reserve consisting of:
(a) The amount of the statutory or unearned premium or reinsurance reserve on the effective date of this Act, which balance shall be released in accordance with the law in effect at the time such sums were added to the reserve; and

(b) Out of total charges for policies of title insurance written or assumed commencing with the effective date of this Act, and until December 31, 1997, a title insurer shall add to and set aside in this reserve an amount equal to [insert amount] of the sum of the following items set forth in the title insurer’s most recent annual statement on file with the commissioner:

(i) Direct premiums written;

(ii) Escrow and settlement service fees;

(iii) Other title fees and service charges including fees for closing protection letters; and

(iv) Premiums for reinsurance assumed less premiums for reinsurance ceded during year.

(c) Additions to the reserve after January 1, 1998 shall be made out of total charges for title insurance policies and guarantees written, equal to the sum of the following items, as set forth in the title insurer’s most recent annual statement on file with the commissioner:

(i) For each title insurance policy on a single risk written or assumed after January 1, 1998, [insert amount] per $1,000 of net retained liability for policies under $500,000 and [insert amount] per $1,000 of net retained liability for policies of $500,000 or greater; and

(ii) [Insert amount] of escrow, settlement and closing fees collected in contemplation of the issuance of title insurance policies or guarantees.

(d) The aggregate of the amounts set aside in this reserve in any calendar year pursuant to Subsections B(2)(b) and B(2)(c) shall be released from the reserve and restored to net profits over a period of twenty (20) years pursuant to the following formula: thirty-five percent (35%) of the aggregate sum on July 1 of the year next succeeding the year of addition; fifteen percent (15%) of the aggregate sum on July 1 of each of the succeeding two (2) years; ten percent (10%) of the aggregate sum on July 1 of the next succeeding year; three percent (3%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; two percent (2%) of the aggregate sum on July 1 of each of the next three (3) succeeding years; and one percent (1%) of the aggregate sum on July 1 of each of the next succeeding ten (10) years.

(e) The insurer shall calculate an adjusted statutory or unearned premium reserve as of the effective date of this Act. The adjusted reserve shall be calculated as if Subsections B(2)(b) through B(2)(d) of this section had been in effect for all years beginning twenty (20) years prior to the effective date of this Act. For purposes of this calculation, the balance of the reserve as of
that date shall be deemed to be zero. If the adjusted reserve so calculated exceeds the aggregate amount set aside for statutory or unearned premiums in the insurer’s annual statement on file with the commissioner on the effective date of this Act, the insurer shall, out of total charges for policies of title insurance, increase its statutory or unearned premium reserve by an amount equal to one-sixth of that excess in each of the succeeding six years, commencing with the calendar year that includes the effective date of this Act, until the entire excess has been added.

(f) The aggregate of the amounts set aside in this reserve in any calendar year as adjustments to the insurer’s statutory or unearned premium reserve pursuant to Subsection B(2)(e) shall be released from the reserve and restored to net profits, or equity if the additions required by Subsection B(2)(e) of this section reduced equity directly, over a period not exceeding ten (10) years pursuant to the following table:

<table>
<thead>
<tr>
<th>Year of Addition</th>
<th>Release</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1*</td>
<td>Equally over 10 years</td>
</tr>
<tr>
<td>Year 2</td>
<td>Equally over 9 years</td>
</tr>
<tr>
<td>Year 3</td>
<td>Equally over 8 years</td>
</tr>
<tr>
<td>Year 4</td>
<td>Equally over 7 years</td>
</tr>
<tr>
<td>Year 5</td>
<td>Equally over 6 years</td>
</tr>
<tr>
<td>Year 6</td>
<td>Equally over 5 years</td>
</tr>
</tbody>
</table>

* (The calendar year following the effective date of this Act).

C. A supplemental reserve shall be established consisting of any other reserves necessary, when taken in combination with the reserves required by Subsections A and B of this section, to cover the company’s liabilities with respect to all losses, claims and loss adjusted expenses.

D. Each title insurer subject to the provisions of this Act shall file with its annual statement required under [insert section] a certification by a member in good standing of the American Academy of Actuaries. The actuarial certification required of a title insurer must conform to the National Association of Insurance Commissioners’ annual statement instructions for title insurers.

E. [Temporary Provision] The supplemental reserve required under Subsection C of this section shall be phased in as follows: twenty-five percent (25%) of the otherwise applicable supplemental reserve will be required until December 31, 1997; fifty percent (50%) of the otherwise applicable supplemental reserve will be required until December 31, 1998; and, seventy-five percent (75%) of the otherwise applicable supplemental reserve will be required until December 31, 1999.

24. The Annual Statement Instructions for Schedule P include the following guidance (only the pertinent excerpts are included below):

Discounting of loss and loss adjustment expense reserves is allowed only if expressly permitted by the state insurance department to which this annual statement is being filed. If discounting of loss and loss adjustment expense reserves is reflected on Page 3 of this annual statement, a reconciliation is provided in Schedule P, Part 1. Work papers relating to any discount amounts must be available for examination upon request.
Generally Accepted Accounting Principles

25. FAS 60 provides the following guidance related to premium revenue recognition on long-duration contracts:

15. Premiums from long-duration contracts, such as whole-life contracts (including limited-payment and single-premium life contracts), guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

16. Premiums from title insurance contracts shall be considered due from policyholders and, accordingly, recognized as revenue on the effective date of the insurance contract. However, the binder date (the date a commitment to issue a policy is given) is appropriate if the insurance enterprise is legally or contractually entitled to the premium on the binder date. If reasonably estimable, premium revenue and cost relating to title insurance contracts issued by agents shall be recognized when the agents are legally or contractually entitled to the premiums, using estimates based on past experience and other sources. If not reasonably estimable, premium revenue and costs shall be recognized when agents report the issuance of title insurance contracts.

26. FAS 60 provides the following guidance related to claim cost recognition:

17. A liability for unpaid claim costs relating to insurance contracts other than title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when insured events occur. A liability for estimated claim costs relating to title insurance contracts, including estimates of costs relating to incurred but not reported claims, shall be accrued when title insurance premiums are recognized as revenue (paragraphs 15 and 16).

18. The liability for unpaid claims shall be based on the estimated ultimate cost of settling the claims (including the effects of inflation and other societal and economic factors), using past experience adjusted for current trends, and any other factors that would modify past experience. Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. Estimated recoveries on unsettled claims, such as salvage, subrogation, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the liability for unpaid claims. Estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims.

4 Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60(d)).

19. Real estate acquired in settling mortgage guaranty and title insurance claims shall be reported at fair value, that is, the amount that reasonably could be expected to be received in a current sale between a willing buyer and a willing seller. If no market price is available, the expected cash flows (anticipated sales price less maintenance and selling costs of the real estate) may aid in estimating fair value provided the cash flows are discounted at a rate commensurate with the risk involved. Real estate acquired in settling claims shall be separately reported in the balance sheet and shall not be classified as an investment. Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred.

20. A liability for all costs expected to be incurred in connection with the settlement of unpaid claims (claim adjustment expenses) shall be accrued when the related liability for unpaid claims is accrued. Claim adjustment expenses include costs associated directly with specific claims paid or in the process of settlement, such as legal and adjusters’ fees. Claim adjustment expenses
also include other costs that cannot be associated with specific claims but are related to claims paid or in the process of settlement, such as internal costs of the claims function.\textsuperscript{5}

\begin{itemize}
\item[	extsuperscript{5}] Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.
\end{itemize}

27. Accounting for title plant is contained in FAS 61, as amended by FAS 121. Pertinent excerpts are as follows:

1. A title plant consists of (a) indexed and catalogued information for a period concerning the ownership of, and encumbrances on, parcels of land in a particular geographic area; (b) information relating to persons having an interest in real estate; (c) maps and plats; (d) copies of prior title insurance contracts and reports; and (e) other documents and records. In summary, a title plant constitutes a historical record of all matters affecting title to parcels of land in a particular geographic area. The number of years covered by a title plant varies, depending on regulatory requirements and the minimum information period considered necessary to issue title insurance policies efficiently. Title plants are updated on a daily or other frequent basis by adding copies of documents on the current status of title to specific parcels of real estate.

3. Costs incurred to construct a title plant, including the costs incurred to obtain, organize, and summarize historical information in an efficient and useful manner, shall be capitalized until the title plant can be used by the enterprise to do title searches. To qualify for capitalization, costs need to be directly related to, and properly identified with, the activities necessary to construct the title plant.

4. Purchased title plant, including a purchased undivided interest in title plant, shall be recorded at cost at the date of acquisition. For title plant acquired separately, cost shall be measured by the fair value of consideration given.

5. An enterprise may decide to construct or purchase a title plant that antedates the period covered by its existing title plant (backplant). Costs to construct a backplant need to be identifiable to qualify for capitalization.

6. Capitalized costs of title plant shall not be depreciated or charged to income unless circumstances indicate that the carrying amount of the title plant has been impaired.

7. Costs incurred to maintain a title plant and to do title searches shall be expensed as incurred. Title plant maintenance involves the updating of the title plant on a daily or other frequent basis by adding (a) reports on the current status of title to specific parcels of real estate and (b) other documents, such as records relating to security or other ownership interests. Title searches involve the process of searching through records for all recorded documents or updating information summarized in the most recently issued title report.

8. Costs incurred after a title plant is operational (a) to convert the information from one storage and retrieval to another or (b) to modify or modernize the storage and retrieval system shall not be capitalized as title plant. Those costs, however, may be capitalized separately and charged to expense in a systematic and rational manner.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 37 - Mortgage Loans
- Issue Paper No. 40 - Real Estate Investments
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 53 - Property and Casualty Contracts - Premiums
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Title Insurers Model Act, dated April 1996
- NAIC Annual Statement Instructions Title

Generally Accepted Accounting Principles
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 61, Accounting for Title Plant
- FASB Statement No. 121, Accounting for The Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of

State Regulations
- Review of state regulations for 38 states with respect to premium reserves.
Statutory Issue Paper No. 59

Credit Life and Accident and Health Insurance Contracts

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance on policy reserves for credit life and accident and health insurance contracts, as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50), is addressed in Chapter 10, Aggregate Reserves for Life and Annuity Contracts and Chapter 13, Aggregate Reserves for Accident and Health Policies of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). That guidance addresses policy reserves related to all credit life and accident and health insurance contracts. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods or an actuarial reserve not less than the gross unearned premium reserve.

2. GAAP requires insurance contracts to be classified as short-duration or long-duration contracts. Long-duration contracts include contracts, such as whole-life, guaranteed renewable term life, endowment, annuity, and title insurance contracts, that are expected to remain in force for an extended period. Other insurance contracts are generally considered short-duration contracts and include most property and liability insurance contracts as well as credit life and accident and health insurance contracts. Premiums from short-duration contracts ordinarily are recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. Claim costs, including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer, are recognized when insured events occur.

3. The purpose of this issue paper is to establish statutory accounting principles for credit life and accident and health insurance contract premium recognition and policy reserves that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). Credit life and accident and health insurance contracts will be referred to collectively as “credit insurance” for purposes of this issue paper.

SUMMARY CONCLUSION

Definitions
4. Credit insurance is generally issued in connection with the issuance of credit to an individual by a bank, retailer, finance company, or other similar organization. This type of insurance most often protects the creditor to the extent of the unpaid balance of the loan. Contracts sold in connection with loans or other credit transactions, not exceeding a stated duration shall be reported as credit insurance. Mortgage guaranty insurance is addressed in Issue Paper No. 88 - Mortgage Guaranty Insurance. Credit policies are generally limited to issues of 120 months or less in most states. Credit insurance is sold as either an individual or group policy and may provide for single or joint life coverage.
5. Credit life insurance, generally in the form of decreasing term insurance, is issued on the lives of debtors to cover payment of loan balances in case of death. Credit accident and health insurance is insurance on a debtor to either provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled.

6. Premiums for credit insurance contracts shall be defined as the contractually determined amount charged by the insurance company to the policyholder for the effective period of the contract.

Income Recognition and Policy Reserves

7. Consistent with Issue Paper No. 51 - Life Contracts (Issue Paper No. 51), premiums shall be recognized in the summary of operations as income on the gross basis (amount charged to the policyholder) when due from policyholders under the terms of the insurance contract.

8. Policy reserves are established through either a gross unearned premium reserve or a mortality/morbidity reserve. The gross unearned premium reserve represents the estimated amount of premium for insurance coverage that has not yet expired. The mortality/morbidity reserve represents the estimated amount of future anticipated benefits, discounted at valuation interest and mortality/morbidity, to be incurred on policies in force. Policy reserves meet the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

9. When the level of insurance risk is constant during the contract period, policy reserves shall be recognized over the period of risk using either the daily pro-rata or monthly pro-rata methods as described in Issue Paper No. 53 - Property and Casualty Contracts - Premiums (Issue Paper No. 53). Policy reserves for contracts where the level of insurance risk is not constant throughout the contract period shall be recognized over the period of risk in proportion to the amount of insurance protection provided. Various methods may be used to accomplish this as discussed in paragraphs 21 to 23. The reporting entity shall select the method that most closely reflects the pattern of insurance protection provided.

10. For credit accident and health contracts, the policy reserve recorded shall not be less than the gross unearned premium reserve. In addition, for all credit contracts in the aggregate, if the premium refund liability exceeds the aggregate recorded reserve, an additional liability shall be established. This premium refund (excess) liability may include consideration of commission, premium tax and other expenses recoverable.

11. The difference between the policy reserves at the beginning and end of the reporting period shall be reflected as the change in reserves or change in unearned premium, as appropriate, in the summary of operations, except for any difference due to a change in valuation basis. A change in valuation basis shall be accounted for consistent with paragraph 24 of Issue Paper No. 51.

12. When the anticipated benefits, expected dividends to policyholders and maintenance cost exceed the recorded policy reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed.

DISCUSSION

13. This issue paper expands on current statutory guidance by requiring that policy reserves on credit insurance contracts be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. Under current statutory accounting, credit life policy reserves may be based on either a gross unearned premium reserve or a mortality reserve. Credit accident and health policy reserves are established through a gross unearned premium reserve computed under various methods. Additionally, this issue paper modifies current statutory accounting by requiring the recognition of a premium deficiency in circumstances described in the preceding paragraph. Current statutory...
guidance does not specifically address premium deficiency reserves. These changes were made to improve consistency in accounting and reporting for credit insurance contracts.

GAAP Literature

14. Consistent with Issue Papers Nos. 50, 51 and 54 - Individual and Group Accident and Health Contracts (Issue Paper No. 54), FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97) and FASB Statement 120, Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts (FAS 120), are rejected for the reasons set forth in those issue papers. However, the GAAP concept of recognizing policy reserves over the period of risk in proportion to the amount of insurance protection provided has been considered in this issue paper.

Characteristics of Credit Life and Accident and Health Insurance Contracts

15. Accounting for credit life and accident and health insurance is significantly affected by the premium mode and the nature of the risks assumed. Both of these factors shall be considered in determining the most appropriate method in which to recognize the policy reserve over the exposure period of the contract in proportion to the amount of insurance protection provided.

16. The premium mode may be either a single premium or a monthly premium based on the outstanding loan balance. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. The single premium is generally remitted to the insurer at the time the loan is made. Premiums which are collected monthly based on the insurance protection provided are generally the monthly outstanding balance type. Outstanding balance rates, used generally for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.

17. The nature of the risks assumed are impacted by the loan conditions as well as the type of coverage or benefits provided. Loan conditions include the loan term, amount, payment pattern, and interest rate. Coverage or benefit types for credit life insurance policies are generally either gross coverage, net payoff coverage, level coverage, or a combination of insurance plans. Gross coverage insures the gross indebtedness of a loan in the form of decreasing term insurance and is used for closed end loans such as installment loans. Net payoff coverage provides decreasing term insurance protection where the death benefit is equal to the scheduled amount due under a debt obligation at any time. This normally includes the outstanding principal and insurance premiums, plus any accrued interest since the last payment. Net payoff coverage is generally used for open end loans in which the monthly payment is not fixed (e.g., lines of credit, home equity loans, and variable rate loans). Level coverage is generally used for single payment closed-end loans and provides for the full payment of the loan at maturity using level term insurance as the plan of insurance. Balloon loans provide for monthly installment payments, plus a lump sum payment at maturity (the balloon). Frequently the installment portion of the loan is covered by decreasing term insurance, while the balloon is covered by level term insurance. Other times, decreasing term coverage is provided as a single policy (certificate) where the last month of the coverage decreases by an amount, or balloon, much greater than the regular monthly installment payment.

18. Credit accident and health insurance policies provide generally a monthly benefit payable as long as the insured remains disabled, or until the scheduled maturity of the loan, if earlier. Since the benefit is the full monthly payment of the loan, including interest charges, the coverage is gross coverage. In some cases, a lump sum, total and permanent disability coverage is offered. This coverage provides for the full payment of the loan balance if the insured is totally and permanently disabled.
Income Recognition and Policy Reserves
19. This issue paper requires gross premiums from credit insurance contracts to be recognized when due and for policy reserves to be recognized over the exposure period of the contract in proportion to the amount of insurance protection provided. To the extent the methods discussed below do not reflect the pattern of insurance protection provided, the insurer should modify or develop, if necessary, a method that recognizes net income from the policy over the exposure period of the contract in proportion to the amount of insurance protection provided.

20. Monthly outstanding balance credit policies are generally collected at the beginning of each month. Consequently, premium is generally earned at the end of the month and a gross unearned premium is only needed to the extent policies are issued during the month. When policies are issued throughout the month, a gross unearned premium reserve should be established based on the remaining proportionate amount of insurance protection to be provided using either the daily pro-rata or monthly pro-rata methods as described in Issue Paper No. 53.

21. Single premium credit life policy reserves shall be based on either a gross unearned premium reserve based on a refund formula, or a reserve based on assumed risks using mortality factors. In practice, various methods exist and are currently used to estimate the amount of gross unearned premiums applicable to the unexpired portion of the policies in force. For decreasing gross coverage, the gross unearned premium may be estimated using a Rule of 78’s method; for decreasing net payoff coverage, either the Rule of 78’s or the single premium method is used; and for level coverage, the pro rata method is generally used. The reporting entity shall select a method that reflects the pattern of insurance protection provided.

22. Policy reserves for credit A&H policies shall be based on a gross unearned premium reserve using either the pro rata, Rule of 78’s, or actuarial methods. The actuarial reserve is the single premium for the debt’s remaining term and amount. Most states require insurers to record a gross unearned premium reserve using the Rule of 78’s method. In practice, a mean gross unearned premium reserve (average of the Rule of 78’s and the pro rata methods) is often recorded. The reporting entity shall select a method that most closely reflects the pattern of insurance protection provided.

23. Recognizing net income in proportion to the amount of insurance protection provided is consistent with the recognition concept in the Statement of Concepts. The recognition concepts states, “revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed.” Therefore, as the period that is protected expires, the underlying underwriting process is completed and the net income should be recognized.

Drafting Notes/Comments
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 53 addresses Property and Casualty Contracts – Premiums.
- Issue Paper No. 54 addresses Individual and Group Accident and Health Contracts.
- Issue Paper No. 55 addresses Unpaid Claims, Losses and Loss Adjustment Expenses.

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RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (only pertinent excerpts are included below)

Statutory Accounting
24. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit life insurance policies:

CHAPTER 10
AGGREGATE RESERVES FOR LIFE AND ANNUITY CONTRACTS

Life Insurance

The fourth line of life insurance is credit. Credit insurance may be either individual or group. All life and all accident and health insurance that is sold in connection with loans or other credit transactions not exceeding a stated duration is to be reported as credit insurance.

Types of Reserves

Reserves for credit insurance to a great extent depend on the premium payment plan which may be either a single premium or a monthly premium based on the outstanding loan balance. If the premium is included as part of the finance charge, and included with the total principal and interest to be paid, it is single premium credit insurance. The single premium is remitted to the insurer at the time the loan is made. State regulations may prohibit remittance of a single premium on a monthly basis by a creditor.

If the premium is collected monthly for the amount of indemnity, the indemnity generally is the outstanding balance type. Reserves for credit life insurance on which premiums are remitted monthly are, in most cases, pro rata unearned premium.

Reserves for single premium credit life may be computed by any of several methods. One method is unearned premium reserves based on the refund formula, usually called Sum of the Digits method or the "Rule of 78's" method. The "Rule of 78's" method assumes that refunds may be made to all insureds. Another method of computation establishes reserves in accordance with the assumed risks. This assumes that refunds will be made as they are experienced in the normal course of business, but not necessarily for all policies. Based on this method, reserves for single premium credit life insurance are established using mortality factors.

25. The Life/A&H Accounting Practices and Procedures Manual provides the following guidance with respect to credit accident and health insurance policies:

CHAPTER 13
AGGREGATE RESERVES FOR ACCIDENT AND HEALTH POLICIES

Credit Insurance

Credit accident and health insurance is insurance on a debtor to provide indemnity for payments becoming due on a specific loan or other credit transaction while the debtor is disabled as defined in the policy. Credit policies are limited to issues of 120 months or less in most states. Some states limit such policies to 60 months.

Credit accident and health insurance is sold as either individual or group coverage, and the reserves are included in the annual statement. Because of the significant growth in recent years of credit insurance coverages of 120 months or less are now reported as a separate line of business in the annual statement.

The premium payment methods of credit insurance may be single premium or monthly premium on the outstanding balance. Outstanding balance rates, used only for group coverage, are determined by multiplying a monthly rate times the amount of outstanding insured indebtedness.
The premium so determined is remitted on each monthly due date to the insurer by the group creditor. Under single premium credit insurance, the premium rate is applied to the initial amount of insurance and generally is included in the debt. Creditors usually remit the single premium for each new insured once a month.

Although credit insurance may be written on an individual or a group basis, the major portion of credit insurance that is written today is group. The two types differ only in form, not in substance. Consequently, they are treated here as one, unless otherwise noted.

Legal Requirements for Reserves

The reserve for single premium credit accident and health insurance is the unearned premium. Three methods are used to calculate unearned premiums: pro rata, “Rule of 78’s,” and actuarial. The actuarial reserve is the single premium for the debt’s remaining term and amount; it is the most accurate method. Pro rata allocates the single premium proportionately to the remaining term, while “Rule of 78’s” does it by using the ratio of the sum of the digits for the remaining term of the sum of the digits for the initial term. The “Rule of 78’s” may substantially underreserve relative to the actuarial reserve.

Quite a few states prescribe minimum reserve standards in their credit insurance regulations. Typically, the requirement for credit A & H is either the gross unearned premium, or the actuarial reserve, but not less than the gross unearned premium. On outstanding balance group credit insurance, the gross unearned premium is generally calculated using the methods described above for other group accident and health policies.

Most companies calculate unearned premium reserves for single premium credit accident and health insurance as average factors. On the actuarial basis, the factor is the average of the single premium rates for the remaining number of months and the remaining number of months less one month. Similarly, companies that use the “Rule of 78’s” will apply an average of 78’s factors. These factors are applied to the single premium and are a function of the original term of the insurance and the number of months remaining in that term. The factor used to compute the reserve will be the average of the “Rule of 78’s” factor for the number of months remaining, and the 78’s factor for one less than the number of months remaining. This half-month assumption in both methods assumes that debtors become insured uniformly throughout each month.

Generally Accepted Accounting Principles

26. FAS 60, as amended by FAS 120, provides the following guidance:

3. Premiums from short-duration insurance contracts, such as most property and liability insurance contracts, are intended to cover expected claim costs resulting from insured events that occur during a fixed period of short duration. The insurance enterprise ordinarily has the ability to cancel the contract or to revise the premium at the beginning of each contract period to cover future insured events. Therefore, premiums from short-duration contracts ordinarily are earned and recognized as revenue evenly as insurance protection is provided.

1 Terms defined in the glossary (Appendix A) are in boldface type the first time they appear in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

General Principles

7. Insurance contracts, for purposes of this Statement, shall be classified as short-duration or long-duration contracts depending on whether the contracts are expected to remain in force for an extended period. The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:
3 In force refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance enterprise.

a. Short-duration contract. The contract provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. Long-duration contract. The contract generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole-life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Accident and health insurance contracts may be short-duration or long-duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long-duration contracts.

9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

Premium Revenue Recognition

Short-Duration Contracts

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

27. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies provides the following guidance:

Term Contracts

8.18 A wide variety of term insurance contracts are issued. The clearly predominant service provided by many such term contracts is protection. Examples of term contracts where the predominant service is protection, include credit life insurance and other types of single or limited payment contracts of a relatively short duration. Gross premium revenues on such contracts should be recognized in proportion to the amounts of insurance in force. Expressed otherwise, written premiums should be recognized as earned during each year that a policy is in force in proportion to the ratio of the amount of insurance in force each year to the total of the annual amounts in force over the life of the policy.
8.23 The accounting for accident and health insurance policies, which are expected to be in force for a reasonable period of time and for which elements of expense or benefit costs are not level, should follow the same principle of accounting as followed for whole-life insurance. Accordingly, premium revenues should be recognized over the premium-paying period. For other kinds of health insurance, gross premiums should be recognized as revenues on a pro rata basis over the period covered by the premium except in those cases of credit accident and health where the coverage decreases by passage of time. For the latter type contracts, gross premiums should be recognized as revenues over the stated period of the contract in reasonable relationship to the anticipated claims.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 10, Aggregate Reserves for Life and Annuity Contracts, and Chapter 13, Aggregate Reserves for Accident and Health Policies
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 53 - Property and Casualty Contracts - Premiums
- Issue Paper No. 88 - Mortgage Guaranty Insurance

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 120, Accounting and Reporting by Mutual Life Assurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 65

Property and Casualty Contracts

STATUS
Finalized March 16, 1998

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Current statutory accounting for property and casualty insurance contracts is provided in Chapters 10, 11, 12, 14, 17 and 21 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual). Property and casualty insurers may issue contracts that have unique features or require specific accounting treatment. Policies may be issued on a claims made basis, certain claims may be of the nature that it may be appropriate to discount the liabilities established, or such that the claim can be satisfied by purchasing an annuity or similar type investment to fund claim payments. Title insurance is a property and casualty insurance contract that is unique and is therefore specifically addressed in Issue Paper No. 57 - Title Insurance.

2. GAAP guidance is provided in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113), AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies (AICPA P&C Audit and Accounting Guide) and in AICPA Statement of Position 94-5, Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises (SOP 94-5).

3. The purpose of this issue paper is to establish statutory accounting principles for property and casualty insurance contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In recent years insurers have begun offering policies with unique reporting features. Paragraphs 5 through 10 of this issue paper relate to policies commonly referred to as “claims made” policies. Property and casualty insurance contracts can be written to cover insured events on different reporting bases as follows:

   a. Occurrence - these policies cover insured events that occur within the effective dates of the policy regardless of when they are reported to the insurer.

   b. Claims made - these policies cover insured events that are reported (as defined in the policy) within the effective dates of the policy subject to retroactive dates where applicable. Unlike an occurrence policy where a liability is recorded when the event occurs, a liability for a claims made policy shall be recorded when the event is reported to the insurer.

   c. Extended reporting - Endorsements to claims made policies covering insured events reported after the termination of a claims made contract but subject to the same retroactive dates where applicable. See paragraphs 7 and 8 for guidance for when premium shall be earned and losses shall be recorded.
Claims Made Policies

5. When an insured obtains claims made coverage they are normally replacing existing coverage. The existing coverage may have been a claims made policy or an occurrence policy. In either case, in an effort to reduce premium costs, the insured may request that the claims made coverage only cover claims reported within the effective dates of the policy that occur after a specified date. This specified date is referred to as the retroactive date of the claims made policy. This exclusion eliminates duplicate coverage when converting from occurrence coverage to claims made coverage.

6. The amount of the liability recorded for an insured event shall be determined in accordance with the provisions of paragraphs 6 through 12 of Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55).

7. Premiums shall be recognized in accordance with Issue Paper No. 53 - Property Casualty Contracts - Premiums (Issue Paper No. 53) unless the policy contains tail coverage as discussed in the following paragraphs.

8. An insured may be provided an extended reporting option to allow extended reporting of events. The extended reporting feature is commonly referred to as “tail coverage”. Extended reporting provisions provided on a claims made policy modify the exposure period of the underlying contract and can be for a defined period (e.g., six months, one year, five years, etc.) or can be for an indefinite period.

9. Issue Paper No. 53 states “Premiums from property and casualty contracts shall be recognized in the statement of operations, as earned premium using either the daily pro-rata or monthly pro-rata methods...unless a different method is specified in issue papers for specific types of property and casualty contracts”. Therefore, when extended reporting provisions for a defined period are provided to the holder of a claims made policy, the insurer shall establish an unearned premium reserve. This liability shall represent the amount of premium charged for the tail coverage that has not yet expired and shall be earned over the tail period regardless of when the tail coverage is elected. When the claims costs and loss adjustment expenses anticipated to be reported during the extended reporting period, together with expected dividends to policyholders and maintenance cost exceed the recorded unearned premium reserve for a claims made policy, a premium deficiency reserve shall be recognized in accordance with Issue Paper No. 53.

10. When extended reporting provisions are for an undefined or indefinite period the policy has effectively been converted to an occurrence type policy. In such instances the premiums shall be recognized in accordance with Issue Paper No. 53 over the basic coverage period and the insurer shall establish a liability for all insured events that have occurred through the end of the policy period whether or not they have been reported. In establishing such reserves the insurer shall follow the guidance prescribed in Issue Paper No. 55.

Discounting

11. With the exception of fixed and determinable payments such as those emanating from workers’ compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted.

12. Tabular reserves are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.
13. When establishing discounted loss reserve liabilities using a non-tabular method the liability shall be determined in accordance with Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves (Actuarial Standard of Practice No. 20) but in no event shall the rate used exceed the lesser of the following two standards:

   a. If the company’s statutory invested assets are at least equal to the total of all policyholder reserves, the company’s net rate of return on statutory invested assets, less 1.5%, otherwise, the company's average net portfolio yield rate less 1.5% as indicated by dividing the net investment income earned, as indicated by line 8 of the Underwriting and Investment Exhibit of the Annual Statement, by the average of the insurer’s current and prior year total assets, as indicated on page 2 of the most currently filed annual financial statement; or

   b. The current yield to maturity on a United States Treasury debt instrument with maturities consistent with the expected payout of the liabilities.

14. In accordance with Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3), a change in the discount rate used in discounting loss reserves shall be accounted for as a change in estimate. The provisions of Issue Paper No. 3 require changes in estimates to be included in the statement of operations in the period the change becomes known.

15. Insurers shall disclose the impact of discounting on the reserves for each line of business and reserve category, if any, the discount rate being utilized, and the tables used if applicable, as well as the impact of any change in the discount rate from the prior period. The disclosures required by paragraph 44 of this issue paper shall be made separately for tabular discounting and non-tabular discounting.

Structured Settlements

16. Structured settlements are periodic fixed payments to a claimant for a determinable period, or for life, for the settlement of a claim. Frequently a reporting entity will purchase an annuity to fund these future payments. Reporting entities may purchase an annuity in which the reporting entity is the owner and payee, or may purchase an annuity whereby the claimant is the payee. When annuities are purchased to fund periodic fixed payments they shall be accounted for as follows:

   a. When the reporting entity is the owner and payee, no reduction shall be made to loss reserves and the annuity shall be recorded at its present value and accounted for as an other than invested asset as it meets the definition of an asset described in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. Income from these annuities shall be treated as miscellaneous income. The present value of the annuity and the related amortization schedule shall be obtained from the issuing life insurance company at the time the annuity is purchased.

   b. When a reporting entity has purchased an annuity and the claimant is the payee, the reporting shall reduce the loss reserve to the extent that the annuity provides for funding of future payments. The cost of these annuities shall be recorded as paid losses in such instances.

17. For each year that full financial statements are presented insurers shall disclose the following in accordance with paragraph 43 of this issue paper:

   a. The amount of reserves no longer carried by the insurer because it has purchased annuities with the claimant as payee and the extent to which an insurer is contingently liable for such amounts should the issuers of the annuities fail to perform under the terms of the annuities.
b. The name, location and aggregate statement value of annuities due from any life insurer to the extent that the aggregate value of those annuities, equal or exceed 1% of the reporting entity’s policyholders’ surplus. This disclosure shall include all annuities for which the company has not obtained a release of liability from the claimant as a result of the purchase of an annuity. The company shall also disclose whether such life insurers are licensed in the company’s state of domicile.

Excess Statutory Reserve
18. Current statutory guidance requires insurers to record an excess statutory reserve computed in accordance with the NAIC Annual Statement Instructions to Schedule P - Part 7. The types of insurance that currently are subject to the excess reserve are:

- auto liability
- other liability
- medical malpractice
- workers’ compensation
- credit coverages

19. This issue paper eliminates the requirement to record excess statutory reserves. Excess statutory reserves do not meet the definition of a liability as set forth in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) which states:

For purposes of statutory accounting, a “liability” shall be defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s). A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. This includes but is not limited to liabilities arising from policyholder obligations (e.g. policyholders benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a Company's financial statements when incurred.

Policies with Coverage Periods Equal to or in Excess of Thirteen Months
20. Some property and casualty insurance contracts are written for coverage periods that equal or exceed thirteen months. These contracts may be single premium or fixed premium policies. These contracts generally are not subject to cancellation or premium modification by the insurer. The most common types of coverages with such periods offered by insurers are home warranty and mechanical breakdown. Revenues are generally not received in proportion to the level of exposure or period of exposure. In order to recognize the economic results of the contract over the contract period, statutory accounting must focus on establishing a liability for the estimated future policy benefits while taking into account estimated future premiums to be received. Insurers that issue such policies shall report unearned premiums in accordance with paragraph 47 of this issue paper. This guidance is primarily focused on home warranty and mechanical breakdown coverages and is not intended to include multiple year contracts comprised of single year policies each of which have separate premiums and annual aggregate
deductibles. This issue paper rejects current statutory guidance for warranty insurance reserves found in Chapter 12, Unearned Premiums, of the P&C Accounting Practices and Procedures Manual.

**High Deductible Plans**

21. Recently insurers have begun offering certain coverages, particularly workers’ compensation coverage, under high deductible plans. These types of plans are different than self insurance coupled with an excess of loss policy in that state laws generally require the insurer to fund the deductible and to periodically review the financial viability of the insured and make an assessment of the suitability of the deductible plan to the insured. Several issues surrounding these types of plans exist, including the recording of claims below the deductible limit and the recording of the reimbursement of the deductible to the insurer.

22. Reserves for claims arising under high deductible plans shall be established net of the deductible, however, no reserve credit shall be permitted for any claim where any amount due from the insured has been determined to be uncollectible. The insurer shall disclose in the notes to the financial statements the amount of reserve credit that has been recorded for high deductibles on unpaid claims and the amounts that have been billed and are recoverable on paid claims.

23. If the policy form requires the insurer to pay for all claims including those under the deductible limit the insurer is subject to credit risk, not underwriting risk. The reimbursement of the deductible shall be accrued and recorded as a reduction of paid losses simultaneously with the recording of the paid loss by the insurer. Amounts accrued for the reimbursement of the deductible shall be billed in accordance with the provisions of the policy and the billed amount shall be accounted for as an asset. Ten percent of deductible recoverable in excess of collateral specifically held and identifiable on a per policy basis, must be reported in the annual statement as a nonadmitted asset, however, to the extent that amounts in excess of the 10% are not anticipated to be collected they shall be nonadmitted.

**Environmental Exposures**

24. Environmental exposures are any loss or potential loss, including third party claims, related directly or indirectly to the remediation of a site arising from past operations or waste disposal. Examples of environmental exposures include but are not limited to chemical waste, hazardous waste treatment, storage, or disposal facilities, industrial waste disposal facilities, landfills, superfund sites, toxic waste pits, and underground storage tanks.

25. Insurers that are potentially exposed to asbestos or environmental claims shall provide the disclosures required by paragraph 46 of this issue paper. Reserves for asbestos and environmental exposures shall be recorded consistently with Issue Paper No. 55.

**Policyholder Dividends**

26. Dividends to policyholders become liabilities of the company immediately when they are declared by the board of directors and shall be recorded as a liability in the annual statement. Incurred policyholder dividends are reported in the Statement of Income.

**DISCUSSION**

**Claims Made Policies**

27. This issue paper requires the recognition of an unearned premium reserve for claims made policies with defined extended reporting provisions and an unpaid loss reserve for claims made policies with undefined extended reporting periods, whereas current statutory guidance permits that such liabilities be reported with unearned premiums or loss reserves for those losses that have been incurred but not reported regardless of the nature of the extended reporting feature. This issue paper also requires insurers to record a premium deficiency reserve in instances when claim and loss adjustment expenses anticipated during a defined extended reporting period, together with certain other costs as described in paragraph 9 exceed the unearned premium reserve. Eliminating the option to record these reserves as loss reserves
when there is a defined extended reporting period is consistent with the concept that under claims made reporting policies, no loss has been incurred until it has been reported to the insurer. This change was made to be consistent with Issue Paper No. 53 which requires premiums to be earned over the period of exposure. Requiring these reserves to be classified as losses when a claims made policy has effectively been converted to an occurrence policy through an undefined extended reporting period is consistent with Issue Paper No. 55.

**Discounting**

28. The statutory principles outlined in the conclusion above are consistent with current statutory guidance for property and casualty insurance contracts. It expands current statutory guidance to permit insurers to use a discount rate that can be supported by Actuarial Standard of Practice No. 20 when discounting indemnity reserves established for future cash payments that are both fixed and determinable. Current statutory guidance limits the discount rate to that permitted by the insurer’s domiciliary state. This change was made for consistency with the Statement of Concepts which states:

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

29. FAS 60 states that the liability for unpaid claims shall be based on the ultimate cost of settling claims and also requires disclosure of amounts of reserves that are discounted as well as the range of discount rates used. No guidance is provided in FAS 60 with respect to the types of reserves that may be discounted. The Securities and Exchange Commission (SEC) permits discounting liabilities for unpaid loss and loss adjustment expenses at the same rates used for reporting to state regulatory authorities with respect to the same claim liabilities. Current practice under GAAP is to follow the SEC guidelines resulting in certain workers’ compensation reserves and medical malpractice reserves being recorded at discounted amounts.

**Structured Settlements**

30. This paper adopts current statutory guidance for structured settlements. GAAP for structured settlements is found in FAS 113. FAS 113 is addressed in its entirety in Issue Paper No. 75 - Property and Casualty Reinsurance. Statutory accounting and GAAP are consistent for the accounting of structured settlement annuities where the insurer is the owner and payee, and where the claimant is the owner and payee and the insurer has been released from its obligation. GAAP distinguishes those structured settlement annuities where the owner is the claimant and a legally enforceable release from the insurer’s liability is obtained from those where the claimant is the owner and payee but the insurer has not been released from its obligation. GAAP requires the deferral of any gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the insurer has not been released from its obligation. Structured settlement annuities are an established practice and the pricing of annuities purchased from non-affiliates is dictated by an effective market. As a result statutory accounting views these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition.

**Excess Statutory Reserves**

31. This issue paper eliminates the requirement to record excess statutory reserves. Historically, the requirement to record excess statutory reserves was a useful method to assist regulators in monitoring insurers and helped provide a level of conservatism in the liabilities established for losses and loss adjustment expenses. Current statutes in most states now require audited financial statements as well as actuarial certifications of the reported liabilities for losses and loss adjustment expenses for property and
32. Excess statutory reserves do not meet the definition of a liability as set forth in Issue Paper No. 5. The conclusion reached in this issue paper is consistent with the Statement of Concepts which states:

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies.

33. This conclusion is consistent with Issue Paper No. 55 which requires management of the insurer to record their best estimate of the liability for losses and loss adjustment expenses. GAAP does not require excess statutory reserves to be recorded and therefore the conclusions reached in this issue paper are consistent with GAAP.

Policies with Coverage Periods Equal to or in Excess of Thirteen Months
34. This issue paper adopts current statutory guidance for policies with coverage periods equal to or in excess of thirteen months and extends the guidance to cover warranty insurance reserves. This is consistent with GAAP which requires that premiums from contracts for which the period of risk differs significantly from the contract period be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

High Deductible Plans
35. Current statutory guidance for high deductible plans is limited and practice varies. Some insurers attempt to bifurcate the amounts collected into premiums for the risks above the deductible and an administrative fee for administering the claims below the deductible. This has the effect of eliminating a portion of premium taxes that would otherwise be paid. Some insurers report the claims under the deductible limit as losses while others do not, and some insurers report the deductible reimbursement as premium while others do not. This issue paper requires insurers to record as a reduction of paid losses, all amounts that represent contractual reimbursements to the insurer.

36. Treatment of claims below the deductible limit for high deductible plans as a reduction of paid losses of the insurer is consistent with the insurer having no underwriting risk associated with the deductibles. Although the existence of the deductible does not eliminate the insurer’s obligation to pay the claim the accounting treatment afforded the deductible is similar to ceded reinsurance balances.

Environmental Exposures
37. This issue paper adopts current statutory guidance for environmental exposures. While GAAP does not specifically address environmental exposures the Securities and Exchange Commission has issued guidance for public companies that is consistent with the current statutory requirements.

Policyholder Dividends
38. This issue paper is consistent with current statutory guidance for policyholder dividends for property casualty insurers. GAAP, for the recognition of policyholder dividends, is to accrue an estimate for amounts that will be paid even though they have not yet been declared by the board of directors. The accounting in this issue paper is a departure from Issue Paper No. 5 and from GAAP. However, codifying current statutory accounting was deemed appropriate as there are no apparent solvency concerns as a result of current statutory accounting for policyholder dividends.

Disclosure
39. The disclosure requirements of this issue paper provide for disclosures in those circumstances where the accompanying exhibits are not part of the company’s financial statements (e.g., annual audit report) and are not intended to provide duplicative presentation in the annual statement filings.
Drafting Notes/Comments
- Reinsurance is addressed in Issue Paper No. 75 - Property and Casualty Reinsurance.
- Title insurance is addressed in Issue Paper No. 57 - Title Insurance.
- Discounting is prohibited by Issue Paper No. 55 unless it is specifically provided for in a specific issue paper.
- Financial guaranty insurance is addressed in Issue Paper No. 69 - Financial Guaranty Insurance.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
40. The P&C Accounting Practices and Procedures Manual, Chapter 10, Losses, provides the following guidance:

Structured Settlements

If the company has purchased annuities, of which the company is owner and payee, to fund future payments that are fixed or determinable by settlement provisions or by workings of statutes, the present value of such annuities shall be disclosed in the annual statement as assets under "Aggregate write-ins for other than invested assets." Income from these annuities is to be reported as "Aggregate write-ins for miscellaneous income" on Page 4 of the annual statement. The company shall not treat such transactions as paid losses. If the company discounts the applicable loss reserve as a result of the purchase of such annuity, the appropriate discounting disclosure is required (see Loss Reserve Discounting below.)

If the claimant is the payee, the company may treat such transactions as paid losses. Appropriate disclosure of the contingent liability for such amounts must be disclosed in Notes to the Financial Statements of the annual statement.

Only if the company assigns the obligation to make periodic payments to a third party and obtains a full and complete release from the claimant, may the claim be treated as a paid claim without additional disclosure.

Claims-Made Policies

In recent years some companies have issued "claims-made" policies for some liability coverages. Under these policies, losses are recognized as they are reported to the company rather than as they occur. The annual statement instructions have some special provisions for reporting losses under these policies.

These policies frequently have extended reporting period provisions. The IBNR reserve should include provision for claims which will be reported under the extended reporting period coverage.

Loss Reserve Discounting

Present value discounting of property and casualty loss reserves is not a generally accepted statutory accounting practice except as respects fixed and determinable payments such as those emanating from workers’ compensation tabular indemnity reserves (defined below) and long-term disability claims. In the event, however, that an insurer is authorized by its domiciliary state to discount its liability loss reserves, the insurer should complete annual statement Schedule P as required by the annual statement instructions. The insurer should also complete the annual statement Note — Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses as required by the annual statement instructions.

Tabular reserves are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.
Statutory Reserve Computation — Schedule P

Minimum statutory reserve calculations are made for auto liability, other liability, medical malpractice, workers' compensation, and credit coverages. Except for credit, the statutory reserve amount is calculated by comparing total losses and loss expenses incurred to earned premiums. Required ratios are set forth in the annual statement instructions for Schedule P.

The statutory reserve for credit is computed in accordance with annual statement instructions.

If a statutory reserve is required, it is shown as a liability on the annual statement. The offsetting charge is to surplus.

41. The P&C Accounting Practices and Procedures Manual, Chapter 12, Unearned Premiums, provides the following guidance:

Claims Made Extended Reporting Coverage Options Relating to Death, Disability or Retirement

Some claims-made policies provide extended reporting coverage at no additional charge in the event of death, disability or retirement of a natural person insured. In such instance, a policy reserve is required to assure that amounts collected by insurers to pay for these benefits are not earned prematurely and that an insurer with an aging book of business will not show adverse operating results simply because an increasing portion of insureds is earning the benefits for which it has paid.

Insurers providing future benefits under this endorsement should include an incremental premium charge for this coverage. It is important that a proportion of each years premiums be set aside to fund this liability. The concept of level funding, applied to these grants of extended reporting coverage is that the indicated incremental premium should not vary because an insurer: is just starting to write this business and does not expect any extended reporting options to be claimed in the near future; or has provided this type of coverage for several years and continues to write new business; or has ceased writing substantial amounts of new business but continues to renew existing accounts, expecting to grant increasing amounts of extended reporting coverage options without additional premium. Periodically insurers should re-evaluate the actuarial assumptions underlying the level premium charge based on any relevant information available at that time.

The amount of the policy reserve, when combined with premium appropriate for an on-going book of business, including some charge for extended reporting coverage, should be adequate to pay for all future claims arising from these coverage features. These future claims include those covered by future grants of extended reporting coverage, without diminishing future profitability below normal expectations for on-going business. If the loss rates for providing this coverage to an aging population are low enough to indicate a negative reserve, then the policy reserve should be set at zero.

Reserve estimates will normally assume that a portion of the existing population of insureds will not continue with the same insurer until qualifying for the benefit and exercising the option. Funding should not anticipate vesting or cash values for individual insureds unless specifically provided by contract.

These additional factors should be considered in estimating the reserve:

1. Loss trends;
2. Time value of money;
3. Nonrenewal rates;
4. Age and tenure eligibility requirements in the contracts;
5. Age and tenure demographics of the insured population;
6. Mortality considerations;
7. Morbidity considerations;
8. Pricing differentials (if any) related to age of insured;
9. Expected claim costs in relation to age of the insured and the number of years until retirement;
10. Waivers (if any) of charges for specialty changes before retirement;
11. Partial benefits (if any) for termination by either the insured or the insurer prior to retirement; and
12. Other factors that impact the value of future benefits.

Insurers may want to use policy reserving techniques that incorporate elements of life actuarial models in addition to the standard property and casualty actuarial techniques in establishing this policy reserve. This reserve, entitled extended reporting endorsement policy reserve, is most appropriately classified as a component part of the unearned premium reserve and should be considered to run more than one year from the date of the policy. The amount of the policy reserve and the accounting/actuarial policies used in determining it should be disclosed in a footnote to the financial statements. When the policy reserve is reviewed or computed at the close of each accounting period, the change in the policy reserve will flow into the net underwriting gain or loss which will result in a better matching of income and expense over the accumulation period of the policy benefit. In addition, an IBNR loss reserve will be established for those insureds which have exercised the extended reporting coverage option.

This reserve may alternatively be considered a claims reserve and included with unpaid losses by an insurer which has obtained authorization to do so from the commissioner of the state of domicile.

**Unearned Premiums - Annual Statement Reporting**

The Underwriting and Investment Exhibit of the annual statement shows the development of the unearned premium reserve, by line of business, net of reinsurance premiums assumed and ceded. The exhibit displays unearned premiums for policies running one year or less and for policies running more than one year. In addition, the exhibit shows the unearned premium reserves associated with advance premiums and with rate credits and retrospective adjustments. Advance premiums result when policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are considered to be fully unearned. This unearned premium reserve is reported in the Liabilities, Surplus and Other Funds Exhibit of the annual statement.

As an alternative, companies may accumulate advance premiums in a suspense account until the effective dates of these policies. In this case, companies must then report the amount of the suspense account as a separate liability, Advance Premiums, on Page 3 of the annual statement under aggregate write-ins for liabilities. Using this treatment, companies would not include advance premiums in either written premium or the unearned premium reserve.

**Unearned Premium - Warranty Insurance Reserves**

For purposes of this rule, warranty insurance is defined as insurance covering mechanical breakdown, service contract agreements or maintenance agreements. At any point before the expiration of the insurance contract or policy the company is required to establish a portion of the premium as a liability to cover the remaining policy term. The unearned premium reserve shall equal the gross premium (after proportional reinsurance) multiplied by the ratio of expected future losses and expenses from the unexpired term of the contract to the total expected losses and expenses under the contract.

42. The NAIC Annual Statement Instructions to Schedule P provide the following guidance with respect to calculating the excess of statutory reserves over statement reserves:

**SCHEDULE P - INTERROGATORIES**

(I) Computation of excess statutory reserves over statement reserves. A percentage minimum loss and loss expense ratio is determined which is then applied to the net
earned premiums. The result is then compared to the net losses and loss expenses incurred to give the required excess statutory reserves. If the company has permission from its state of domicile to discount loss and loss expense reserves, the company should compute the excess of statutory reserves over statement reserves using its discounted loss and loss expense reserves rather than the undiscounted reserves. The computation is required only for Auto Liability (Private Passenger and Commercial), Other Liability (including Products Liability), Medical Malpractice, Workers' Compensation, and Credit.

If the company was not in existence for the full five years prior to the statement date, this calculation should be based on the years in which the company was in existence.

Private Passenger Auto Liability and Commercial Auto Liability must be combined before calculating the statutory percentage. Occurrence and claims-made coverages must be combined for Other Liability (including Products Liability) and Medical Malpractice, respectively, before calculating the statutory percentage.

(a) Other than Credit. The percentage to be used is based on the company's actual loss and expense ratios in the five years immediately prior to the most recent three, provided that at least three of the five years have at least $1 million in net earned premium. See Schedule P, Part 1, Column 4 for premiums and Column (30) for loss and expense ratios. Use the lowest ratio of losses and loss expenses incurred for these years using only years which have at least $1 million in net earned premium. If the lowest qualifying ratio is less than 60%, then use 60% (65% for Workers' Compensation). If the lowest qualifying ratio is more than 75%, then use 75%. If at least three of the five years do not have at least $1 million in net earned premium, use 60% (65% for Workers' Compensation). Round percentage to nearest tenth of one percent. Indicate percentage used. The same percentage should be used for the three most recent years. The excess statutory reserve over the statement reserve is this percentage times the earned premium in Column 4 less the incurred amount in Column 27 for the required years. If negative, enter zero. Do not include premiums and losses for non-proportional insurance shown in Parts IN, IO, IP, and 1Q.

(b) Credit. Use the following formula and carry the result over to the annual statement.

1. Net unpaid losses on policies expired prior to October 1, current year
2. Reserve for Losses on policies expired in October, November and December, current year:
   (a) Net Premiums written on such policies
   (b) 50% of (a)
   (c) Net losses paid under such policies
   (d) Difference (b)-(c)
   (e) Net losses unpaid under such policies
   (f) Difference (d)-(e), show zero if negative
3. Reserve for accrued losses on policies in Force December 31, current year:
   (a) Net Premiums earned under such policies
   (b) 50% of (a)
   (c) Net losses paid under such policies
   (d) Difference (b)-(c)
   (e) Net losses unpaid under such policies
   (f) Difference (d)-(e), show zero if negative
4. Excess of Statutory Reserve over Statement Reserves 2(f) + 3(f) (Carry result over to annual statement.)
43. The NAIC Annual Statement Instructions, Note 14, provide the following guidance with respect to disclosure of structured settlements:

14. Structured Settlements
   a. Instruction:
      If the company has purchased annuities, under which the company is owner and payee, to fund future payments that are fixed or determinable by settlement provisions or by workings of statutes, the present value of such annuities shall be disclosed as assets under "Aggregate write-ins for other than invested assets" on Page 2 of the annual statement. The present value of the annuities should be obtained from the issuing life insurance company at the time the annuity is purchased. At the same time, an amortization schedule should be obtained since annual adjustments to the annuity's carrying value are necessary. If the total value of all annuities due from one life insurer equals or exceeds 1 percent of the Company's policyholders' surplus, list the life insurer's name and location (headquarters); whether the life insurer is licensed in the company's state of domicile (i.e., yes or no is the requested response); and the statement value (i.e., present value) of the annuity(ies). The requested information is illustrated below. In addition, show the aggregate amount (i.e., present value) of annuities due from all life insurers.

   Illustration:
   Life Insurance Company and Location
   Licensed in Company's State of Domicile
   Statement Value (i.e., Present Value) of Yes/No Annuities

   b. Instruction:
      If the company has purchased annuities of which the claimant is payee but for which the company is contingently liable, the amount of such contingent liability shall be disclosed in the Notes to Financial Statements, Note #8. This contingent liability is the amount of the liability due to the various claimants that have been offset by the purchase of the annuity. This liability may be measured by the amortized value (i.e., the present value obtained from the life insurer) of the annuities offsetting the liabilities. If the total value (i.e., present value) of all annuities due from one life insurer equals or exceeds 1 percent of the company's policyholders' surplus, list the life insurer's name and location (headquarters) and the amount of the reserve eliminated when the annuity was purchased. Report the total amount of loss reserves eliminated by annuities. This reserve is measured by the amortized value of the annuities offsetting the reserve. The requested information is illustrated below. In addition, show the aggregate amount (i.e., the present value which is obtained from the life insurer) of annuities due from all life insurers.

   Illustration:
   Life Insurance Company and Location
   Loss Reserves Eliminated by Annuities

   i. Total $
is required to respond to this note in the affirmative for non-tabular discounting, it must also respond in the affirmative to Schedule P Interrogatory #5, and complete Columns 31 and 32 of Part 1, Part IA, etc., of Schedule P.

If the answer is in the affirmative, furnish the following information for each line of business affected:

a. If a tabular basis is used:
   1. Identify table used.
   2. Rate(s) used to discount.
   3. The amount of discounted liability carried in the annual statement.
   4. The amount of tabular discount, disclosed by line of business and reserve category (i.e., case and IBNR).

Definition of Tabular Reserves:

Tabular reserves by accident year are indemnity reserves that are calculated using discounts determined with reference to actuarial tables which incorporate interest and contingencies such as mortality, remarriage, inflation, or recovery from disability applied to a reasonably determinable payment stream. This definition shall not include medical loss reserves or any loss adjustment expense reserves.

b. If a non-tabular basis is used:
   1. Rate(s) used to discount and the basis for the rate(s) used.
   2. Amount of non-tabular discount disclosed by line of business and reserve category (i.e., case, IBNR, Allocated Loss Adjustment Expense and Unallocated Adjustment Expense).
   3. The amount of non-tabular discounted liability carried in the annual statement.

c. If the rate(s) used to discount prior accident years' liabilities have changed from the previous annual statement:
   1. Amount of discounted current liabilities at current rate(s) assumption(s). (Exclude the current accident year.)
   2. Amount of discounted current liabilities at previous rate(s) assumption(s). (Exclude the current accident year.)
   3. Change in discounted liability due to change in interest rate(s) assumptions. (I-2)
   4. Amount of non-tabular discount, disclosed by line of business and reserve category (i.e., case, IBNR, allocated loss adjustment expense and unallocated loss adjustment expense).

Illustration:
The Company discounts the liabilities for unpaid losses for Workers' Compensation and Medical Malpractice claims. The Company does not discount unpaid loss adjustment expenses.

Reserves for Workers' Compensation claims have been discounted on a tabular basis using the _________ Table at ___%. The December 31, 19XX and December 31, 19XX liabilities include $____________ and $____________ of such discounted reserves, respectively. The amount of discount for case and IBNR reserves at December 31, 19XX is as follows:
### Tabular Discount Included in Schedule P

**Schedule P Lines of Business**

<table>
<thead>
<tr>
<th>Part I *</th>
<th></th>
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<tbody>
<tr>
<td>(1)</td>
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<td>(2)</td>
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<tr>
<td>Case</td>
<td>IBNR</td>
<td></td>
</tr>
</tbody>
</table>

| (1) | Homeowner/Farmowners |
| (2) | Private Passenger Auto Liability/Medical |
| (3) | Commercial Auto/Truck Liability/Medical |
| (4) | Workers’ Compensation |
| (5) | Commercial Multiple Peril |
| (6.1) | Medical Malpractice - occurrence |
| (6.2) | Medical Malpractice - claims made |
| (7) | Special Liability |
| (8.1) | Other Liability - occurrence |
| (8.2) | Other Liability - claims made |
| (9) | Special Property |
| (10) | Auto Physical Damage |
| (11) | Fidelity, Surety |
| (12) | Other (including Credit, Accident & Health) |
| (13) | International |
| (14) | Reinsurance A |
| (15) | Reinsurance B |
| (16) | Reinsurance C |
| (17) | Reinsurance D |
| (18.1) | Products Liability - occurrence |
| (18.2) | Products Liability - claims made |
| (19) | Financial Guaranty/Mortgage Guaranty |
| (20) | Total |

* Must exclude medical loss reserves and all loss adjustment expense reserves

Medical Malpractice unpaid losses have been discounted on a non tabular basis using rates of from ____% to ____%. The discount rates used are based upon ______________. The amount of the discount as of December 31, 19XX and December 31, 19XX respectively is $ _________ and $ _________ for losses and $ _________ and $ _________ for loss adjustment expense. The amount of discount at December 31, 19XX for case, IBNR, allocated LAE and unallocated LAE is as follows:

### Non-Tabular Discount

**Schedule P Lines of Business**

<table>
<thead>
<tr>
<th>Non-Tabular Discount *</th>
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<tbody>
<tr>
<td>(1)</td>
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<td>Case</td>
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</tbody>
</table>

<p>| (1) | Homeowners/Farmowners |
| (2) | Private Passenger Auto Liability/Medical |
| (3) | Commercial Auto/Truck Liability/Medical |
| (4) | Workers’ Compensation |
| (5) | Commercial Multiple Peril |
| (6.1) | Medical Malpractice - occurrence |</p>
<table>
<thead>
<tr>
<th>(6.2)</th>
<th>Medical Malpractice - claims made</th>
</tr>
</thead>
<tbody>
<tr>
<td>(7)</td>
<td>Special Liability</td>
</tr>
<tr>
<td>(8.1)</td>
<td>Other Liability - occurrence</td>
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<tr>
<td>(8.2)</td>
<td>Other Liability - claims made</td>
</tr>
<tr>
<td>(9)</td>
<td>Special Property</td>
</tr>
<tr>
<td>(10)</td>
<td>Auto Physical Damage</td>
</tr>
<tr>
<td>(11)</td>
<td>Fidelity, Surety</td>
</tr>
<tr>
<td>(12)</td>
<td>Other (including Credit, Accident &amp; Health)</td>
</tr>
<tr>
<td>(13)</td>
<td>International</td>
</tr>
<tr>
<td>(14)</td>
<td>Reinsurance A</td>
</tr>
<tr>
<td>(15)</td>
<td>Reinsurance B</td>
</tr>
<tr>
<td>(16)</td>
<td>Reinsurance C</td>
</tr>
<tr>
<td>(17)</td>
<td>Reinsurance D</td>
</tr>
<tr>
<td>(18.1)</td>
<td>Products Liability - occurrence</td>
</tr>
<tr>
<td>(18.2)</td>
<td>Products Liability - claims made</td>
</tr>
<tr>
<td>(19)</td>
<td>Financial Guaranty/Mortgage Guaranty</td>
</tr>
<tr>
<td>(20)</td>
<td>Total</td>
</tr>
</tbody>
</table>

* Should include medical loss reserves and all loss adjustment expense reserves, whether reported as tabular or non-tabular in Schedule P.

The rates used to discount Medical Malpractice unpaid losses at December 31, 19XX have changed from the rates used at December 31, 19XX. At December 31, 19XX, the amount of discounted Medical Malpractice unpaid losses, excluding the current accident year, is $__________. Had these unpaid losses been discounted at the rates used at December 31, 19XX the amount of discounted liabilities would be $__________. The reduction in the discounted liability due to the change in rates is $__________.

This illustration neither regulates, permits, nor prohibits the practice of discounting liabilities for unpaid losses or unpaid loss adjustment expenses.

45. Chapter 21, Dividends to Policyholders, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to policyholder dividends:

Most state insurance statutes establish the conditions under which dividends may be declared and paid to the policyholder. In general, they provide that dividends to policyholders become liabilities of the company immediately when they are declared by the board of directors. The dividends may be paid only out of unassigned (earned) surplus, in accordance with the rates approved by the board of directors. No dividend may be declared or paid when the surplus of a company is less than the minimum original surplus that is required for the kind or kinds of business which the company is authorized to transact. Also, no dividend may be declared or paid when the payment would reduce the company’s surplus below its required minimum. No dividend may be declared or paid that is contrary to any restriction contained in the company’s articles of incorporation. Certain states have additional restrictions on declaration of dividends to policyholders.

State statutes usually provide that a company’s board of directors or trustees may declare dividends to its policyholders and, in so doing, may establish reasonable classifications or groupings of policyholders and reasonable plans for the distribution of such dividends. This may be done for each general kind and group or class of insurance, and may establish reasonable territorial divisions upon policies expiring during a fixed period.

In establishing the liability for dividends declared and unpaid, the dividend scale approved by the board of directors is applied to all policies in the designated groups or classes.
The amount of policyholder dividends declared and unpaid should be recorded as a liability in the annual statement. Incurred policyholder dividends are reported in the Statement of Income; the amount so reported includes the paid amount (typically recorded as paid in the ledger asset reconciliation) plus the amount accrued at the end of the year (the dividends declared and unpaid), less the amount accrued at the beginning of the year.

46. The NAIC Annual Statement Instructions, Note 24, provide the following guidance with respect to environmental disclosures:

24. Asbestos/Environmental (Mass Tort) Reserves

Instruction:

If the company is potentially exposed to asbestos and/or environmental claims (mass tort), full disclosure of the reserving methodology for both case and IBNR reserves is required. Disclosure of the amount paid and reserved for losses and LAE for asbestos and/or environmental claims, on a gross and net of reinsurance basis, is also required.

Does the company have on the books or has it ever written an insured for which you have identified a potential for the existence of a liability due to asbestos and/or environmental losses? Yes ( ) No ( )

If yes, describe the lines of business written for which there is potential exposure, the nature of the exposure or exposures and the company's methodology for reserving for both reported and IBNR losses.

If yes, complete the following information, separately for asbestos-related and environmental losses (including coverage dispute costs) for each of the five most current calendar years on both a gross and net of reinsurance basis (more detailed breakdowns are acceptable):

- Beginning reserves: $________
- Incurred losses and loss adjustment expenses: ________
- Calendar year payments for losses and loss adjustment expenses:
- Ending reserves: $________

If yes, complete the following, separately for asbestos-related and environmental reserves:

Does the company hold reserves for unreported claims? Yes ( ) No ( )

Does the company hold reserves for future allocated loss adjustment expenses (including coverage dispute cost)? Yes( ) No ( )

Definition of Environmental Loss

Any loss or potential loss (including third-party claims) related directly or indirectly to the remediation of a site arising from past operations or waste disposal.

Examples of Environmental Exposure:

- Chemical Waste
- Hazardous Waste TSD Facilities (Treatment, Storage and/or Disposal)
- Industrial Waste Disposal Facilities
- Landfills
- Superfund
- Toxic Waste Pits
- Underground Storage Tanks
47. The Financial Condition (EX4) Subcommittee adopted the following guidance at the June 7, 1995 meeting of the Subcommittee. The guidance was adopted by the full membership of the NAIC at the September 11, 1995 Plenary Session.

Unearned Premium Reserve - Single or Fixed Premium Policies with Coverage Periods in Excess of Thirteen Months

This rule shall apply to all contracts or policies (contracts), excluding financial guaranty contracts, mortgage guaranty products, and surety contracts that fulfill both of the following conditions:

1. The policy or contract term is greater than or equal to 13 months.
2. The insurer can neither cancel the contract, nor increase the premium during the policy or contract term.

At any valuation date prior to the expiration of the contracts, the company is required to establish an adequate premium reserve, to be reported as the unearned premium reserve for the contracts, on all appropriate annual statement lines and exhibits. Each of the following three tests shall be calculated, for all direct and assumed contracts, in the aggregate by policy year for each line of business with the gross premium reserve being equal to the greatest of the following calculations for each policy year for each line of business. Any reserve credit applicable for reinsurance ceded shall be appropriately reflected in the annual statement with the resulting net premium reserve being established by the company. For reporting net information on the NAIC financial reporting blank, the UPR shall be recalculated on a net basis, which may include appropriate statutory permitted credits for reinsurance, salvage and subrogation.

1. The best estimate of the amounts refundable to the contractholders at the valuation date.
2. The gross premium multiplied by the ratio of (a) over (b), where:
   (a) equals the best estimate of future expected gross losses and expenses to be incurred during the unexpired term of the contracts; and
   (b) equals the best estimate of the total expected gross losses and expenses under the contracts.

The future and total expected losses and expenses are to be re-estimated no less frequently than annually, and the most recent estimate of these expected losses is to be used in this test.

3. The amount of the present value of the future expected gross losses and expenses to be incurred during the unexpired term of the contracts, reduced by the present value of the future guaranteed gross premiums, if any. In the calculation of the present value:
   (a) Discounting is only permitted for future expected losses and expenses, and not incurred but unpaid losses and expenses.
   (b) Losses and expense provisions may be discounted from the expected date the loss or expense is incurred, not from the expected date of payment, unless such lines of business are permitted to be discounted by the state of domicile.
   (c) The rate of interest used to calculate the present values shall be reviewed and changed as necessary at each valuation date determined as not to exceed the lesser of the following two standards.
      (i) if the company's statutory invested assets are at least equal to the total of all policyholder reserves, the company's net rate of return on statutory invested assets, less 1.5%, otherwise, the company's average net
portfolio yield rate less 1.5% as indicated by dividing the net investment income earned, as indicated by line 8 of the Underwriting and Investment Exhibit of the NAIC Annual Statement, by the average of the insurer’s current and prior year total assets, as indicated on page 2 of the most currently filed annual financial statement; or

(ii) the current yield to maturity on a United States Treasury debt instrument maturing in five (5) years as of the valuation date.

For the purposes of tests (2) and (3) above, “expenses” shall include all incurred and anticipated expenses related to the issuance and maintenance of the policy, including loss adjustment expenses, policy issuance and maintenance expenses, commissions, and premium taxes.

This unearned premium methodology will result in premium earning patterns which are inconsistent with the assumptions implicit with the excess of statutory reserves over statement reserve calculation. Therefore, contracts subject to this rule will not be required to be included in such Schedule P Interrogatories calculation.

This section shall immediately apply to all in force and subsequent business. At the company’s option, the impact of this rule with regard to the choice of the interest rate under section 3 may be uniformly phased in over a three year period. The amount phased in shall be limited to the difference between the amounts calculated by using the rate mandated by this rule and the rate actually used by the company for discounting as of 12/31/94, so long as the latter rate does not exceed the constant treasury maturity rate determined by using yields from treasury bills with durations which match the duration of the company’s existing liabilities for the inforce which is affected by this rule.

Additionally, where this rule produces a higher reserve than the company would have established through the use of their previous methodology, the company may request a phase in period, of not to exceed three years, from it domiciliary Commissioner. Such phase in period shall only be permitted if the company is able to demonstrate to the satisfaction of the Commissioner that it would not be operating in a hazardous financial condition and that there is not adverse risk to its insureds.

Generally Accepted Accounting Principle

48. The AICPA P&C Audit Guide provides the following guidance:

Accounting Principles
3.29 The specialized industry accounting principles for insurance enterprises are specified in FASB Statement No. 60. The following is a brief discussion of the principles and policies relating to the premium cycle. Readers should refer to the FASB Statement for specific guidance. Most property and liability insurance contracts are classified as short-duration contracts, and this guide generally focuses on such contracts.

Revenue Recognition
3.30 Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company’s balance sheet.
3.31 As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

The Loss Reserving and Claims Cycle Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, and SOP 92-5, Accounting for Foreign Property and Liability Reinsurance.

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage and subrogation are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued Staff Accounting Bulletin No. 62, Discounting by Property/Casualty Insurance Companies, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Staff Accounting Bulletin No. 87, Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5, Accounting for Contingencies, contingency disclosures and Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies, which provides the SEC staff’s interpretation of current accounting literature relating to the following:

*Offsetting of probable recoveries against probable contingent liabilities*
*Recognition of liabilities for costs apportioned to other potential responsible parties*
*Uncertainties in estimation of the extent of environmental or product liability*
*The appropriate discount rate for environmental or product liability, if discounting is appropriate*
Accounting for exit costs
Financial statement disclosures and disclosure of certain information outside the basic financial statements

Salvage and Subrogation

4.30 After a claim has been settled, the possibility of salvage or subrogation may exist. Perhaps the simplest approach to determining the anticipated receivable is to estimate loss reserves using loss data that is net of salvage and subrogation recoveries. Many of the reserving methods for losses and loss adjustment expenses, however, can also be used to estimate salvage and subrogation recoveries.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 10, 11, 12, 14, 17 and 21
- NAIC Annual Statement Instructions to Schedule P
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 53 - Property Casualty Contracts - Premiums
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 57 - Title Insurance
- Issue Paper No. 66 - Accounting for Retrospectively Rated Contracts
- NAIC Annual Statement Instructions to notes 14, 19, and 24
- Minutes to the Financial Condition (EX4) Subcommittee meeting of June 7, 1995.

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies

State Regulations
- Texas Alternative Calculation for Schedule P reserves for High Deductible Plans
- Arkansas Insurance Department Bulletin 14-93 Guidelines for Implementation of Large Deductible Workers’ Compensation Programs
- Florida Regulations FAC Rule 4-189.006 Guidelines for Large Deductible Workers’ Compensation Filings
- Massachusetts Regulations 211 CMR 113.04 Workers’ Compensation Deductibles Plan

Other Sources of Information
- Actuarial Standard of Practice No. 20, Discounting of Property and Casualty Loss and Loss Adjustment Expense Reserves.
Statutory Issue Paper No. 66

Accounting for Retrospectively Rated Contracts

STATUS
Finalized June 23, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A retrospectively rated contract is one which has final policy premium calculated based on the loss experience of the insured or subscriber during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The periodic adjustment involves either the payment of return premium to the insured or subscriber or payment of an additional premium by the insured or subscriber, or both, depending on experience. Retrospective rating features are common in certain property and casualty contracts, group life, and group accident and health contracts. Contracts with retrospective rating features are referred to as loss sensitive contracts.

2. Current statutory guidance for accounting for retrospectively rated contracts is contained in Chapter 12, Unearned Premiums, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual) and Chapter 13, Aggregate Reserves for Accident and Health Policies, and Chapter 15, Liabilities Related to Policyholder Dividends, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) and the NAIC Annual Statement Instructions (Annual Statement Instructions). This guidance requires the recognition of a liability for return premium due to an insured or subscriber and an asset for additional premium due from an insured or subscriber under a retrospectively rated contract. Retrospective premiums reported as assets are subject to various requirements for asset admissibility.

3. GAAP guidance for accounting for retrospectively rated contracts is contained in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), and FASB Emerging Issues Task Force Issue No. 93-14, Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises (EITF 93-14). This guidance also requires the recognition of a liability for return premium due to an insured and an asset for additional premium due from an insured under a retrospectively rated insurance contract.

4. The purpose of this issue paper is to establish statutory accounting principles for retrospectively rated contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper applies to property and casualty contracts, life insurance contracts and accident and health contracts. Retrospective reinsurance contracts are not within the scope of this issue paper, they are addressed in Issue Paper No. 75 - Property and Casualty Reinsurance.

SUMMARY CONCLUSION

5. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts meet the definition of assets and liabilities as set forth in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) and Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), respectively. Amounts due from insureds and amounts due to insureds under retrospectively rated contracts are admitted assets to the extent they conform to the requirements of this issue paper.

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7. Because policy periods do not always correspond to reporting periods and because an insureds loss experience may not be known with certainty until some time after the policy period expires, retrospective premium adjustments shall be estimated based on the experience to date using one of the following methods:

a. Property and Casualty Contracts
   i. Use of actuarially accepted methods in accordance with filed and approved retrospective rating plans. This includes but is not limited to the application of historical ratios of retrospective rated developments to earned standard premium to develop a ratio which is then applied to those policies for which no retrospective calculation has been recorded or for which no modification to the recorded calculation is needed. This method results in the calculation of one amount which is either a net asset or a net liability;
   
   ii. Reviewing each individual retrospectively rated risk, comparing known loss development (including IBNR) with that anticipated in the policy contract to arrive at the best estimate of return or additional premium earned at that point in time. This method results in the calculation of an asset or a liability for each risk. The total of all receivables shall be recorded as an asset and the total of all return premiums shall be recorded as a liability.

b. Life and Accident & Health Contracts: Reporting entities offering group coverage have extensive underwriting procedures and complex individually negotiated benefits and contracts. Due to cost and reporting deadlines, these factors make it difficult to establish an exact valuation of retrospective premium. The method used to estimate the liability shall be reasonable based on the reporting entity’s procedures, and consistent among reporting periods. Common methods include a mathematical approach using a complex algorithm of the reporting entity’s underwriting rules and experience rating practices, and an aggregate or group approach.

8. Assumptions used in estimating retrospective premium adjustments shall be consistent with the assumptions made in recording other assets and liabilities necessary to reflect the underwriting results of the reporting entity such as claim and loss reserves (including IBNR) and contingent commissions. Contingent commissions and other related expenses shall be adjusted in the same period the additional or return retrospective premiums are recorded.

9. Retrospective premium adjustments are estimated for the portion of the policy period that has expired and shall be considered an immediate adjustment to premium. Additional retrospective premiums and return retrospective premiums shall be recorded as follows:

a. Property And Casualty Insurers:
   i. Accrued additional retrospective premiums shall be recorded as a receivable with a corresponding entry made either to written premiums or as an adjustment to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed;
   
   ii. Accrued return retrospective premiums shall be recorded as a write-in liability with a corresponding entry made either to written premiums or as an adjustment
to earned premiums. Premiums not recorded through written premium when accrued shall be recorded through written premium when billed.

iii. Ceded retrospective premium balances payable shall be recorded as liabilities, consistent with Issue Paper No. 75 - Property and Casualty Reinsurance. Ceded retrospective premiums recoverable shall be recorded as an asset. Consistent with Issue Paper No. 76—Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76), ceded retrospective premium balances payable may be deducted from ceded retrospective premiums recoverable when a legal right of setoff exists.

b. Life and Accident & Health Insurers:

i. Accrued additional retrospective and other premiums shall be recorded as a write-in for other than invested assets, with a corresponding entry made to premiums;

ii. Accrued return retrospective and other premiums shall be recorded as a liability, Provision for experience rating refunds, with a corresponding entry to premiums.

10. The amount of accrued estimated retrospective premiums to be recorded as a nonadmitted asset for property and casualty insurers shall be determined as follows:

a. 100% of the amount recoverable from any person for whom any agents’ balances or uncollected premiums are classified as nonadmitted, and item (b), plus item (c) or (d) below. Once an insurer has elected either (c) or (d) below, a change from one to the other requires approval from the insurer’s domiciliary state and such change must be disclosed in the financial statements.

b. Retrospective premium adjustments shall be determined and billed or refunded in accordance with the policy provisions or contract provisions. If accrued additional retrospective premiums are not billed in accordance with the policy provisions or contract provisions, the accrual shall be nonadmitted.

c. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an “A” or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as described in Appendix A-785. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

d. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (types of acceptable collateral vary from state to state) or by financial guaranty coverage issued by an insurer having an “A” or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy
the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

<table>
<thead>
<tr>
<th>Insured’s Current Quality Rating*</th>
<th>Insured’s Corporate Debit Equivalent to (S&amp;P/Moody’s)**</th>
<th>Percentage of Retro Premium to be Nonadmitted***</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 AAA, AA, A/Aaa, Aa, A</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>2 BBB/Baa</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>3 BB/Ba</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>4 B/B</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>5 CCC, CC, C/Caa, Ca</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>6 CI, D/C, or insured in default on debt service payments, or insured’s debt service payments are jeopardized upon filing of a bankruptcy petition</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

* The Percentage of Retro Premium to be Nonadmitted is based upon the Insured’s Current Quality Rating (i.e., if an insured’s quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC’s Securities Valuation Office (SVO).

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO) the insured’s quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

11. Once accrued retro premiums are billed, the due date is governed by Issue Paper No. 6 - Amounts Due From Agents and Brokers (Issue Paper No. 6) (if premium is agency billed), or Issue Paper No. 10 - Uncollected Premium Balances (Issue Paper No. 10) (if premium is direct billed). Life and accident & health insurers shall nonadmit any accrued retrospective premium that is more than 90 days due. If a reporting entity has more than one policy with the same insured, retrospective balances shall be netted in accordance with Issue Paper No. 76.

12. If, in accordance with Issue Paper No. 5, it is probable that the additional retrospective and other premium is uncollectible, any uncollectible additional retrospective and other premium shall be written off against operations in the period the determination is made. If it is reasonably possible a portion of the balance in excess of the nonadmitted portion determined in accordance with paragraph 11 of this issue paper is not anticipated to be collected, the disclosure requirements outlined in Issue Paper No. 5 shall be made.
Disclosure
13. The financial statements shall disclose the method used by the reporting entity to estimate retrospective and other premium adjustments. The amount of net premiums written that are subject to retrospective rating features and other adjustments, as well as the corresponding percentage to total net premiums written, shall be disclosed.

14. The financial statements shall disclose the calculation of nonadmitted retrospective premium. If a reporting entity chooses treatment described in paragraph 10 (c) or (d), the appropriate exhibit must be included in the notes to financial statements in the Annual Statement. Once a reporting entity has elected either 10 (c) or (d), a change from one to the other requires approval from the reporting entity’s domiciliary state and such change must be disclosed in the financial statements.

DISCUSSION
15. This issue paper addresses premium adjustments for retrospectively rated contracts. Premium adjustments that have been billed are also addressed in Issue Paper No. 6 and Issue Paper No. 10. The statutory principles outlined in the conclusion above are consistent with the current statutory guidance for accounting for retrospectively rated contracts except as follows:

a. Paragraph 10 requires property and casualty entities to record accrued retrospective premium credits as an aggregate write in for other liabilities whereas current statutory provides for retrospective premium credits to be recorded with unearned premiums.

b. Paragraph 12 requires that any impairment of recorded additional retrospective premiums be charged against operations in the period in which the impairment is determined.

c. Paragraph 14 expands the disclosure requirements that are currently in place for property and casualty insurers to life and accident & health entities.

d. Paragraph 11 expands the requirement for accident and health entities to nonadmit any retrospective premium balances that are more than 90 days past due to life insurers.

These changes were made to be consistent with the approach reflected for earned but unbilled premiums (EBUB) in Issue Paper No. 53 and with the approach reflected in Issue Paper No. 5 which requires the recognition of a loss when an asset has been impaired.

16. The statutory principles outlined in the conclusion above are consistent with the guidance provided for accounting for retrospectively rated insurance contracts in FAS 60 and EITF 93-14 with the exception of the requirement to record certain amounts as nonadmitted. Although FAS 60 is rejected in Issue Paper No. 50 - Classifications and Definition of Insurance or Managed Care Contracts In Force and EITF 93-14 is rejected in this issue paper since it applies only to multiple-year retrospectively rated contracts, it is considered appropriate that the accounting for retrospectively rated contracts be consistent with those provisions of both FAS 60 and EITF 93-14 as they are consistent with the Statement of Concepts.

17. The statutory accounting principles outlined in the conclusion above are consistent with the recognition concept in the Statement of Concepts of which a pertinent excerpt follows:

Recognition

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

18. Based on the above concept, accrued retrospective premium balances should reflect only amounts that are available to meet both current and future policyholder obligations. Therefore, amounts determined to be impaired should be charged to income in the period such determination is made. In addition, premium taxes and commissions relating to the accrued retrospective premium should be recorded. The adoption of this methodology will more appropriately provide the statutory financial statement reader with an indication of those assets available to meet policyholder obligations.

19. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts of which a pertinent excerpt follows:

Conservatism

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

Drafting Notes/Comments
- Earned but unbilled premiums are addressed in Issue Paper No. 53 - Property Casualty Contracts Premiums.
- Retrospectively rated reinsurance contracts are addressed in Issue Paper No. 75 - Property and Casualty Reinsurance.
- The definition of loss sensitive contracts included herein includes all contracts with retrospective rating features. The instructions to Schedule P - Part 7 require reporting for loss sensitive contracts subject to very specific percentage changes in premiums based on loss experience.
- Premium adjustments that have been billed are further discussed in Issue Paper No. 6 - Amounts Due from Agents and Brokers and Issue Paper No. 10 - Uncollected Premium Balances.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

20. The P & C Accounting Practices and Procedures Manual, Chapter 7, Agents’ Balances or Uncollected Premiums, provides the following guidance regarding recording accrued retrospective premiums net of ceded reinsurance:

The annual statement blank requires the following separation: (1) premiums and agents' balances in course of collection (i.e., premiums both booked and billed), less ceded reinsurance balances payable; (2) premium, agents' balances and installments booked but deferred and not yet due (e.g., premiums which have been booked but are not yet billed), less ceded reinsurance balances payable; (3) accrued retrospective premiums (i.e., accrued retrospective premiums which have not been booked or billed), less ceded retrospective rated balances payable.

21. The P & C Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets, point 5, lists examples of nonadmitted assets:

Accrued retrospective premiums from whom any agents' balances or uncollected premiums are classified as nonadmitted.

22. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes and Miscellaneous, Instructions and Illustrations of How to Report Information in the Notes to Financial Statements, page 101, provide the following instructions:
Instruction:

Describe the basis used to determine the amount of accrued retrospective premiums reported as admitted assets in Line 9.3.

23. The P & C Accounting Practices and Procedures Manual, Chapter 12, Unearned Premiums, states the methodology that shall be used in determining the unearned premium reserve adjustment relating to accrued retrospective contracts following:

Retrospective Rated Policies

Retrospectively rated policies have a final premium calculated on the experience of the insured during the term of the policy (including developments after the term of the policy) and the stipulated formula set forth in the policy. The adjustment involves either the payment of a return premium to the insured or the payment of an additional premium by the insured.

Recognizing the need for reserve provisions to account for these potential additional or return premiums, provision has been made in the Underwriting and Investment Exhibit of the annual statement for the recording of a special unearned premium reserve fund by line of business called "Reserve for Rate Credits and Retrospective Adjustments Based on Experience". Such amounts should be calculated using actuarially acceptable methods in accordance with filed and approved retrospective rating plans. Accrued net additional retrospective premiums are reported as assets and subject to collateralization requirements for asset admissibility.

Two methods are commonly employed by insurance companies in computing this unearned premium reserve. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. A second method is to review each individual retrospectively-rated risk, comparing known loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time.

24. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Underwriting and Investment Exhibit, Part 2A, Recapitulation of All Premiums, page 59, also sets forth the methodology for calculating and reporting for the reserve for accrued credits and retrospective premium:

The reserve for accrued credits and retrospective return premium adjustments based upon experience, Column 4, may be computed under one of two methods. The first method is to build up for each line by policy year, a historical record of the ratio of retrospective rated developments to earned standard premium. The ratio is then applied to the earned standard premium of those policies for which no retrospective calculation has yet been recorded, producing the indicated unearned premium. The second method is to review each individual retrospectively-rated risk, comparing known loss developments with those anticipated in the policy contract to arrive at the best estimate of return or additional premium due at that point in time. Include, as a negative amount in Column 4, the amount of net accrued retrospective debit adjustments only to the extent they are for incurred (paid and/or unpaid) losses, loss adjustment expenses and, if any, other underwriting expenses also included in the financial statement of the company.

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Exhibit 1, Analysis of Assets, provides additional guidance regarding admissibility:

Line 9.3 - Accrued Retrospective Premiums on Insurance Contracts

Include: Estimated additional direct premiums and assumed premiums accrued that will become due under prescribed terms from insureds or reinsureds under policies or reinsurance agreements containing retrospective rating formulas based on current or expired policies.
experience, but not to exceed the limitations, if any, contained in such policies or reinsurance agreements. Net of reinsurance; plus reinsurance assumed fund balance minus reinsurance ceded balance

Exclude: Agents' balances or uncollected premium items (Line 9.1 and Line 9.2) and accrued rate credits

The amount reported in Column I must be zero and the amount reported in Column 2 must agree with the amount reported on Page 8, Part 2A, Line 33.

Include as non-admitted in Column 3, amounts for accrued retrospective premiums which represent:

a. 100% of the amount recoverable from any person for whom any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as non-admitted (Column 3), and item (b) or (c) below. Once an insurer has elected either (b) or (c) below, a change from one to the other requires approval from the insurer's domiciliary state and such change must be disclosed in Note #1 of Notes to Financial Statements.

b. 10% of any accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss adjustment expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation. Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.

c. An amount calculated using the factors below for accrued retrospective premiums not offset by retrospective return premiums, other liabilities to the same party (other than loss and loss expense reserves), or collateral, not otherwise used. Collateral shall be of the same types and quality permitted for use in connection with reinsurance (see notes to Schedule F) or by financial guaranty coverage issued by an insurer having an "A" or better rating from a nationally recognized rating agency. The financial guaranty coverage must allow the insured under the financial guaranty policy the same degree of access to payments under that policy as a beneficiary has under a qualified letter of credit as per Section 11 of the NAIC Credit for Reinsurance Model Regulation.

Accrued retrospectively rated premiums relating to bulk IBNR must be allocated to individual policyholder accounts prior to categorizing by Quality Rating.
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* The Percentage of Retro Premium to be Nonadmitted is based upon the Current Quality Rating (i.e., if an insured's quality rating drops, the percentage relating to the lower quality rating is used in calculating the amount to be nonadmitted and vice versa).

** Insureds that do not have a debt rating issued by a publicly recognized rating agency are required to be rated by the NAIC's Securities Valuation Office SVO.

*** In the event the insured has no debt rating (either from a publicly recognized rating agency or from the SVO), the insured's quality rating will be considered category 5 for purposes of this calculation (i.e., a factor of 20% shall be applied), unless the insurer is aware of conditions of the insured that would warrant a category 6 classification (i.e., a factor of 100%).

If an insurer chooses item (b) or (c) above, the appropriate exhibit must be included in Note #18 of the Notes to Financial Statements of the annual statement to summarize the calculation of nonadmitted retrospective premium (see instructions to Notes to Financial Statements).

Include as nonadmitted in Column 3, amounts for accrued retrospective premiums on assumed business which represents 100% of the amount accrued (gross of ceded reinsurance) for any reinsured for which any agents' balances or uncollected premiums (Lines 9.1 or 9.2) are classified as nonadmitted (Column 3).

26. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Schedule P Part 7, Supplement for Loss Sensitive Contracts, page 221 requires the following disclosure:

**General**

1. Only the experience on contracts that meet the following definition should be included in Schedule P, Part 7. The experience on all other contracts should not be included.

Loss sensitive contracts shall meet the following criteria:

Contracts where an increase in losses on a policy can cause an increase in net payment (by the insured) for that policy.

The amount of additional payment (by the insured) must be at least 75% (50% for reinsurance contracts) of the additional losses, before application of aggregate and per accident/claimant limits or caps.

The net amount paid (by the insured) must also be able to differ by at least 20% (10% for reinsurance contracts), from highest to lowest possible charge in reaction to the loss experience.
The maximum possible payment by the insured should also be at least 15% (7.5% for reinsurance contracts) above what the insured would pay based on expected loss experience. In other words, the maximum charge should not approximate the expected charge.

The additional payment shall be in the form of additional premiums or additional commissions.

The additional losses and corresponding payments must flow through the income and balance sheets and cannot be "off-balance sheet." For example, a deductible feature does not make a contract "loss sensitive" under this definition, as neither the losses under the deductible nor the reimbursements for these losses flow through the income statement.

2. In all development exhibits, only reported data as of year end 1993 and subsequent is required. Data for prior year ends is encouraged, but not required. For each year end, data for all issue years is required.

3. Schedule P, Part 7 is only required of insurers who claim a reduction in their Risk-Based Capital for Loss Sensitive Contracts. Such insurers must complete the entire schedule in each year that they claim such credit.

4. Schedule P, Part 7A provides experience on primary contracts. Schedule P, Part 7B provides experience on reinsurance contracts. The segregation should be consistent with the Risk-Based Capital formula.

Current Year Loss and LAE Reserves and Net Written Premium

5. Column (2) of Parts 7A and 7B of Schedule P, when combined, should agree with the net loss and loss expense reserves (undiscounted) reported in the corresponding Part I of Schedule P. Column (3) should reflect the reserve for Loss Sensitive Contracts only.

6. Column (5) of Parts 7A and 7B of Schedule P, when combined, should agree with the net written premiums reported in the Underwriting and Investment Exhibit. Column (6) should reflect the corresponding premium for Loss Sensitive Contracts only.

7. Columns (4) and (7) are ratios of (3) to (2) and (6) to (5), respectively. Express as percentages showing one decimal place (e.g., 24.2%).

27. Chapter 13, Aggregate Reserves For Accident And Health Policies, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on individual and group accident and health reserves:

Reserve For Experience-Rating Refunds Or The Dividend Liability In Group Insurance Policies

Some group insurance policyholders may receive partial or full retrospective premium credit for their policy-year experience. On the statutory financial statement date, a provision for the experience rated refund is established based on the experience of the policy year up to the statement date. This liability may include certain funds contributed by the policyholder as a premium stabilization fund. Since many policy years do not end at the statutory financial statement date, subsequent experience may cause the rate credit actually to be greater or less than the liability established on the statement date. For this reason, the rate credit liability becomes a very difficult liability to establish and an equally difficult liability to reconcile. Only for the very smallest of group insurance carriers is it possible to do an exact valuation of this liability based on the company underwriting rules and practices. Larger group insurers have massive texts of underwriting procedures, along with complex individually negotiated benefits and contracts. For reasons of economy and reporting deadlines, few companies can establish an "exact" valuation of this liability. Some companies use a certain approach, using a complex
algorithm of the company’s underwriting rules and experience rating practices. Other companies use aggregate or grouping approaches. Regardless of the approach used, the liability must stand the test of reasonableness and consistency. No company should pay experience refunds unless its contracts provide for such payment.

The experience rating refund may be reported as a separate liability item or may be included as an active life reserve.

28. The Life/A&H Accounting Practices and Procedures Manual, Chapter 15, Liabilities Related to Policyholder Dividends, provides the following guidance with respect to experience rated contracts:

**Experience Rating Refunds (Retrospective Rate Credits)**

Nonparticipating group insurance and pension contracts may be subject to experience rating. Experience credits for a given group are usually developed by determining the excess, if any, of the premium and investment income earned with respect to the group over the corresponding benefits and expenses incurred with respect to the group and applying an appropriate credibility adjustment to that excess.

At specified dates, such as the contract anniversary or the end of the calendar year, the experience of the contract is calculated and the refund, if any, is paid. If the balance sheet date falls between the dates on which the refund is paid, the experience up to the balance sheet date is calculated and the appropriate liability is established.

**Generally Accepted Accounting Principles**

29. FAS 60, paragraph 14, states the following:

If premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:

a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

b. If the ultimate premium cannot be reasonably estimated, the cost of recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

30. FAS 60, paragraph 44, states the following:

**Retrospective and Contingent Commission Arrangements**

If retrospective commission or experience refund arrangements exist under experience-rated insurance contracts, a separate liability shall be accrued for those amounts, based on experience and the provisions of the contract. Income in any period shall not include any amounts that are expected to be paid to agents or others in the form of experience refunds or additional commissions. Contingent commissions receivable or payable shall be accrued over the period in which related income is recognized.

31. EITF 93-14, includes the following:

**ISSUE**

An enterprise (for example, a manufacturing concern, a retailer, a service entity, or a financial institution) enters into a multiple-year retrospectively rated contract with an insurance company.
That contract is similar to the type of contract discussed in Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and may cover various types of exposures such as product and environmental liability risks.

Those contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the noninsurance enterprise, or (2) changes in the contract's future coverage. A critical feature of those contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates for each party to the contract future rights and obligations as a result of past events. A retrospectively rated insurance contract that is not a multiple-year contract or that could be canceled by either party without further obligation is not covered by this Issue. Contracts used by enterprises in certain industries where risks are "pooled," like those discussed in paragraph 45 of Statement 5 and a reinsurance contract entered into by a captive insurer, are addressed by this Issue.

The issue is how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for.

EITF DISCUSSION

The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

For a multiple-year retrospectively rated insurance contract accounted for as insurance, the Task Force reached a consensus that the insured should recognize a liability and the insurer should recognize an asset to the extent that the insured has an obligation to pay cash (or other consideration) to the insurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-without method, as the difference between the insured's total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

If the insured could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and on experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:
   a. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).
   b. The total incremental amount that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).
The insured should recognize an asset and the insurer should recognize a liability to the extent that any cash (or other consideration) would be payable by the insurer to the insured based on experience to date under the contract.

The insured and the insurer should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the insured and as a gain by the insurer when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, if the insured has no future coverage relating to the deposit with the insurer and, therefore, the deposit is not recoverable).

The provisions of this consensus are effective as of November 18, 1993 and should be initially applied no later than the fourth quarter of 1993 for calendar-year enterprises in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise’s current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented. The Task Force noted that the FASB Staff Views on Issue 93-6 that appear as Topic No. D-35 in Appendix D are useful guidance for applying this consensus.

STATUS

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 7, 9 and 12
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies - Chapters 13 and 15
- NAIC Annual Statement Instructions
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 6 - Amounts Due From Agents and Brokers
- Issue Paper No. 10 - Uncollected Premium Balances
- Issue Paper No. 53 - Property Casualty Contracts - Premiums
- Issue Paper No. 75 - Property and Casualty Reinsurance
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities

Generally Accepted Accounting Principles
- FASB Statement 60, *Accounting and Reporting by Insurance Companies*
- FASB Emerging Issues Task Force No. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts*

State Regulations
- No additional guidance from state statutes or regulations.
Statutory Issue Paper No. 67

Depreciation of Property and Amortization of Leasehold Improvements

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

   a. The cost of directly owned property (except land), occupied by the company or held for investment, to be allocated to expense (depreciated) over the property’s estimated useful life in a systematic and rational manner.
   b. The cost of nonadmitted furniture and equipment (including EDP equipment) to either be fully expensed when purchased or depreciated over the property’s estimated useful life.
   c. The cost of leasehold improvements to be allocated to expense (amortized) over the term of the lease.

2. GAAP guidance for accounting for depreciation is provided in Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (ARB 43), Chapter 9, Depreciation, and Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967 (APB 12). This guidance requires that the cost of depreciable assets, less salvage value (if any) be expensed over the estimated useful lives of the assets. GAAP guidance requires a leasehold improvement to be amortized over the remaining term of the lease or its estimated useful life, whichever is shorter.

3. The purpose of this issue paper is to establish statutory accounting principles for accounting for the depreciation of property and the amortization of leasehold improvements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

4. Issue Paper No. 16 - Electronic Data Processing Equipment and Software (Issue Paper No. 16), Issue Paper No. 19 - Furniture, Fixtures and Equipment (Issue Paper No. 19), Issue Paper No. 31 - Leasehold Improvements Paid by the Reporting Entity as Lessee (Issue Paper No. 31), and Issue Paper No. 40 - Real Estate Investments (Issue Paper No. 40) each require the depreciation of these assets against net income as their estimated economic benefit expires.

SUMMARY CONCLUSION

5. The acquisition cost of all depreciable assets, net of salvage, shall be allocated to expense over the estimated useful lives of the assets in a systematic and rational manner. The acquisition cost of a leasehold improvement shall be allocated to expense over the shorter of its estimated useful life or the original lease term excluding options or renewal periods. For leasehold improvements capitalized subsequent to inception of the lease, the cost shall be allocated to expense over the shorter of its estimated useful life or the remaining original lease term excluding options or renewal periods. Amounts capitalized

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for leasehold improvements in periods subsequent to the original lease term (i.e., during renewal periods), are amortized utilizing the shorter of the estimated useful life of the asset or the remaining term of the renewal period. In accordance with the reporting entity’s capitalization policy, immaterial amounts incurred relative to leasehold improvements, can be expensed when purchased.

6. For the purposes of this issue paper, depreciable assets include all tangible capital assets classified as either admitted or nonadmitted in accordance with Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Land shall not be considered a depreciable asset.

7. Depreciation and amortization expense shall be recorded in the statement of income in accordance with Issue Paper No. 94 - Allocation of Expenses (Issue Paper No. 94).

8. A variety of systematic depreciation and amortization methods is available such as the straight-line method, the sum-of-the-years’ digits method, and various declining balance methods. The depreciation or amortization method selected shall be that which most appropriately allocates the cost of the depreciable asset or leasehold improvement over its estimated useful life. The use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice.

9. Useful lives of depreciable assets and leasehold improvements can be obtained from contractors, appraisers, engineers, and manufacturers, or they may be based on prior experience. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets.

10. The following disclosures shall be made in the financial statements or notes thereto:
   a. Depreciation and amortization expense for the period.
   b. A general description of the method or methods used in computing depreciation and amortization with respect to major classes of depreciable assets and leasehold improvements.

11. Changes in the estimated useful lives of depreciable assets or leasehold improvements from one period to another shall be considered a change in accounting estimate and shall be accounted for in accordance with Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3). Changes in depreciation or amortization methods from one period to another shall be considered a change in accounting principle and shall be accounted for in accordance with Issue Paper No. 3.

DISCUSSION

12. The statutory principles outlined in the conclusion above are consistent with current statutory guidance except as follows:
   a. Paragraph 5 requires the acquisition cost of all depreciable nonadmitted assets to be allocated to expense over their estimated useful lives. Current guidance allows nonadmitted depreciable assets to either be expensed when purchased or depreciated.
   b. Paragraph 5 requires a leasehold improvement to be amortized over the shorter of the remaining original term of the lease excluding renewal or option periods or its estimated useful life. Amounts capitalized subsequent to the original lease term (i.e., during a renewal period) are amortized over the shorter of the estimated useful life of the asset or the remaining renewal period. Current guidance requires amortization over the remaining term of the lease.
   c. Paragraph 10 requires disclosures with respect to depreciable assets and depreciation and, leasehold improvements and amortization in the notes to the financial statements.
13. The statutory principles outlined in the conclusion above are consistent with the following issue papers:
   
a. Issue Paper No. 4 which requires that assets be depreciated or amortized against income as the economic benefit expires.
   
b. Issue Paper No. 16 which requires that the cost of electronic data processing equipment and software be depreciated against net income as the estimated economic benefit expires.
   
c. Issue Paper No. 19 which requires that the cost of furniture, fixtures and equipment be depreciated against net income as the estimated economic benefit expires.
   
d. Issue Paper No. 31 which requires that the cost of leasehold improvements be depreciated against net income as the estimated economic benefit expires.
   
e. Issue Paper No. 40 which requires that the cost of property included in real estate investment, other than land, be depreciated over the estimated useful life.

14. This issue paper rejects Chapter 9 of ARB 43 however, it is considered appropriate to use the concepts of depreciating assets discussed in the GAAP guidance, which requires that the acquisition cost less salvage value be recorded as an expense over the estimated useful life of the asset, as the basis for the statutory guidance codified in this issue paper. Additionally, this issue paper rejects APB 12 although the disclosures required by this issue paper are consistent with the disclosures required therein.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

15. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

   **Depreciation and Amortization**

   The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.

   A variety of depreciation methods is available, and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method and accelerated methods, such as sum-of-years’ digits and various declining balance methods.

   Because real estate leasehold improvements revert to the lessor at the end of the lease, and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.


16. The Life/A&H Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets, provides the following guidance:

   **Equipment, Furniture, and Supplies:** The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial
statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

17. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4 provide the following guidance:

The Working Group concluded that the use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice and that the practice should not be applied to new properties acquired in the future nor if the company changes its existing properties’ method of depreciation. This conclusion would not impact those properties currently being depreciated using the constant yield method.

Generally Accepted Accounting Principles

18. Chapter 9, Section C of ARB 43, provides the following guidance:

5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational matter. It is a process of allocation, not of valuation.

19. Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967, provides the following guidance:

DISCLOSURE OF DEPRECIABLE ASSETS AND DEPRECIATION

4. Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.

5. Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:

a. Depreciation expense for the period,

b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,

c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and

d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 9
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 16 - Electronic Data Processing Equipment and Software
- Issue Paper No. 19 - Furniture, Fixtures and Equipment
- Issue Paper No. 31 - Leasehold Improvements Paid by the Reporting Entity as Lessee
- Issue Paper No. 40 - Real Estate Investments
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-1
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-2
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-3
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-4
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-1
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-2
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-3
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4

**Generally Accepted Accounting Principles**
- Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins, Chapter 9, Depreciation*
- Accounting Principles Board Opinion No. 12, *Omnibus Opinion - 1967*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 68

Business Combinations and Goodwill

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance and GAAP differ in accounting for business combinations. Current statutory guidance requires that an investment in a subsidiary, controlled or affiliated entity (SCA) be recorded at historical net asset value of the entity acquired (statutory book value for acquired entities). The difference between the value of the consideration given and the statutory net asset value is considered to be goodwill and under current statutory guidance may be recorded as an admitted asset, subject to certain limitations. Amortization of goodwill is limited to 10 years. However, individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Currently some states allow the admission of goodwill within the limits imposed by the Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners (SVO Purposes and Procedures), other states require goodwill to be nonadmitted.

2. Current statutory guidance does not specifically address the accounting for mergers, other than to require restatement of prior years for the effect of mergers. Current statutory practice is to account for mergers by combining or carrying forward the existing statutory amounts of assets, liabilities and related surplus accounts.

3. Under GAAP, business combinations are accounted for using either the pooling of interests method or the purchase method. GAAP has certain prerequisites which must be met for the pooling of interests method to be applied. This method accounts for a business combination as the uniting of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Therefore, the recorded assets and liabilities of the entities are carried forward at their historical amounts, and the income and expenses of the constituents for the prior periods are combined and retroactively restated.

4. Under GAAP, the purchase method of accounting is applied for business combinations which are not considered poolings of interests. Under the purchase method, the acquiring entity records the assets acquired and liabilities assumed at fair value. The difference between the cost of an acquired entity and the sum of the fair values of tangible and identifiable intangible assets (e.g., present value of future profits of a life entity) less the fair value of liabilities is recorded as goodwill. Amortization of goodwill is over the periods in which the acquiring entity benefits economically, not to exceed 40 years.

5. The purpose of this issue paper is to establish statutory accounting principles for business combinations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It addresses:

- Accounting for purchases of Subsidiary, Controlled and Affiliated (SCA) investments (defined in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities (Issue Paper No. 46)),

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- Accounting for purchases of partnerships, joint ventures and limited liability companies (defined in Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies),
- Accounting for goodwill and
- Accounting for mergers.

SUMMARY CONCLUSION

Business Combinations
6. A business combination shall be accounted for as either a statutory purchase or a statutory merger. Business combinations that create a parent, subsidiary relationship shall be accounted for as a statutory purchase. Business combinations where equity of one entity is issued in exchange for the equity of another entity, which is then canceled, and prospectively only one entity exists, shall be accounted for as a statutory merger.

Statutory Purchases of SCA Investments
7. The statutory purchase method of accounting is defined as accounting for a business combination as the acquisition of one entity by another. It shall be used for all purchases of SCA entities including partnerships, joint ventures and limited liability companies. The acquiring reporting entity shall record its investment at cost. Cost is defined as the sum of a) any cash payment, b) the fair value of other assets distributed, c) the fair value of any liabilities assumed and d) any direct costs of the acquisition. Goodwill is defined as the difference between the cost of acquiring the entity and the reporting entity’s share of the book value of the acquired entity. When the cost of the acquired entity is greater than the reporting entity’s share of the book value, positive goodwill exists. When the cost of the acquired entity is less than the reporting entity’s share of the book value, negative goodwill exists. Goodwill resulting from assumption reinsurance shall be recorded as a separate write-in for other than invested assets. All other goodwill shall be reported in the carrying value of the investment. A business combination accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7 b iii. of Issue Paper No. 46 shall determine the amount of positive goodwill or negative goodwill created by the combination using the reporting entity’s share of the GAAP net book value of the acquired entity. Business combinations accounted for under the statutory purchase method and in which the acquired entity is valued in accordance with paragraph 7 b i. or 7 b ii. of Issue Paper No. 46 shall determine the amount of positive or negative goodwill created by the business combination using the reporting entity’s share of the statutory book value of the acquired entity.

8. Under the statutory purchase method the historical bases of the acquired entity shall continue to be used in preparing its statutory financial statements except in those instances provided for in paragraph 8b. of Issue Paper No. 46. Therefore, pushdown accounting is not permitted.

Positive Goodwill and Negative Goodwill
9. Positive goodwill recorded under the statutory purchase method of accounting shall be admitted subject to the following limitation: Positive goodwill from all sources, including life, accident and health, and deposit-type assumption reinsurance, is limited in the aggregate to 10% of the parent reporting entity’s capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net positive goodwill, EDP equipment and operating system software, and net deferred tax assets. When negative goodwill exists it shall be recorded as a contra-asset. Positive or negative goodwill resulting from the purchase of a SCA shall be amortized to unrealized capital gains and losses on investments over the period in which the acquiring entity benefits economically, not to exceed 10 years. Positive or negative goodwill resulting from life, accident and health, and deposit-type assumption reinsurance shall be amortized to operations as a component of general insurance expenses over the period in which the assuming entity benefits economically, not to exceed 10 years. Goodwill shall be evaluated separately for each transaction.
Statutory Mergers
10. The statutory merger method of accounting is defined as accounting for a business combination in which the original investors in the investee receive equity of the reporting entity for their interest in the investee and only one entity survives. It shall be used for all business combinations accomplished by 1) issuing equity of a newly formed entity for the equity of the merging entities, 2) one entity issuing equity in exchange for the equity of another entity and immediately canceling the equity of that entity, or 3) the exchange of membership interest. Under the statutory merger method, no acquisition shall be recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interest continues and the former statutory bases of accounting shall be retained. However, if one of the merged entities did not employ the statutory basis of accounting, the accounts shall be adjusted to the statutory bases with an offsetting adjustment to beginning surplus of the earliest period presented. The recorded assets, liabilities and related surplus accounts of the constituents shall be carried forward to the combined corporation at their recorded statutory amounts. The capital accounts of the entities shall be adjusted as necessary to reflect the appropriate par values of the capital stock of the new entity. Adjustments to the capital stock account shall be made to gross paid-in and contributed surplus, to the extent there is a balance in the account. Income of the combined entity shall include income of the constituents for the entire fiscal period in which the combination occurs and the balance sheet and the statement of operations for the two years presented shall be restated, as required by Issue Paper No. 3 - Accounting Changes. Goodwill on the historical books of any merged entity that arose from a previous business combination involving the merged companies shall be charged or credited to surplus immediately.

Impairment
11. For any decline in the fair value of an entity, acquired through a purchase that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., nonadmitted goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary, shall be recorded as realized losses. This is consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

Disclosures
12. For business combinations accounted for under the statutory purchase method the financial statements shall disclose the following for as long as unamortized goodwill is reported as a component of the investment:

   a. The name and brief description of the acquired entity;

   b. Method of accounting, that is the statutory purchase method;

   c. Cost of the acquired entity and the amount of goodwill; and

   d. The amount of amortization of goodwill recorded for the period.

13. For business combinations taking the form of a statutory merger the financial statements shall disclose:

   a. The names and brief description of the combined entities;
b. Method of accounting, that is the statutory merger method;

c. Description of the shares of stock issued in the transaction;

d. Details of the results of operations of the previously separate companies for the period before the combination is consummated that are included in the current combined net income, including revenue, net income, and other changes in surplus; and

e. A description of any adjustments recorded directly to surplus for any entity that previously did not prepare statutory statements.

14. The financial statements shall disclose the following information regarding goodwill resulting from assumption reinsurance:

a. The name of the ceding entity;

b. The type of business assumed;

c. The cost of the acquired business and the amount of goodwill; and

d. The amount of amortization of goodwill recorded for the period.

15. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write-down:

a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

b. The amount of the impairment charged to realized capital gains and losses and how fair value was determined.

DISCUSSION

16. The statutory accounting principles described above reject Accounting Principles Board Opinion No. 16, Business Combinations (APB 16) and related interpretive pronouncements, FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, an amendment of APB Opinion No. 16 (FAS 38), and Accounting Principles Board Opinion No. 17, Intangible Assets, (APB 17) and related interpretive pronouncements by limiting the admitted value of an acquired entity. FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (FAS 79) is rejected in this issue paper as the disclosures required by paragraphs 12 and 13 of this issue paper are the same for public and non-public entities. Interpretive literature that is rejected in this issue paper is included in the Relevant GAAP Literature section. This issue paper adopts FASB Emerging Issues Task Force Issue No. 95-19, Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination.

17. Paragraph 8 of this issue paper requires that the historical bases of an acquired entity be carried forward and therefore the allocation of the purchase price is not “pushed-down”. Under GAAP, “push-down” accounting is not specifically promulgated but is suggested as appropriate by the SEC in certain circumstances as described in paragraph 30 below. Push-down accounting is often followed where the investor acquires 90% or more of the ownership interest in the investee. The statutory accounting principles described above reject push-down accounting. Current statutory guidance does not address “push-down” accounting.

18. The conclusions reached in this issue paper with respect to impairment are consistent with paragraph 12 of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for
Long-Lived Assets to be Disposed Of (FAS 121) to the extent that it addresses impairment of goodwill. Paragraph 12 is therefore adopted. Paragraph 13 of FAS 121 is rejected as it addresses the distinction between continuous operations and discontinued operations. The concept of discontinued operations was rejected in Issue Paper No. 24 - Discontinued Operations and Extraordinary Items. Paragraph 14 addresses disclosure requirements for impairments. Subparagraphs 14 a. and 14 b. are adopted. Subparagraph 14 c. is rejected as specific statutory reporting requirements have been addressed in the issue paper. Subparagraph 14 d. is rejected as it refers to business segments. FAS 121 is also addressed in Issue Paper No. 40 - Real Estate Investments.

19. The statutory accounting principles described in the conclusion above are consistent with the current statutory guidance except as follows:

a. Current statutory guidance requires goodwill in excess of 10% of a reporting entity’s statutory capital and surplus to be written off immediately as a direct charge to surplus. The statutory accounting principles above require all unamortized goodwill to be recorded as an asset and any amount in excess of 10% of statutory capital and surplus to be nonadmitted.

b. Current statutory guidance does not specifically address accounting for mergers.

c. Current statutory accounting does not address disclosure of impairments.

20. This change to current statutory referred to in subparagraph 19 a. of this issue paper was made in order to recognize that although regulatory limitations are placed on the admissibility of goodwill, it does represent an asset. Placing limitations on goodwill recognizes that in order to liquidate an investment where the insurer is a significant shareholder, full value of such investment may not be realized.

21. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism and recognition concepts in the Statement of Concepts. Under the statutory purchase method described above, the historical bases of the acquired entity are used to value the investment. Goodwill attributable to an acquired entity is recorded as an asset, and treated as an admitted asset to the extent that, when added to existing recorded goodwill, it does not exceed 10% of the acquiring entity’s capital and surplus. Admitting a portion of the goodwill recognizes that the acquired entity may be sold for fair value (which may include goodwill) to meet and fund policyholder obligations. This is consistent with Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets. Pertinent excerpts from the Statement of Concepts follow:

Conservatism

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

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

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

Drafting Notes/Comments
- Accounting for investments in SCAs after acquisition is addressed in Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities.
- Assumption reinsurance is addressed in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners, Section 5. Procedures for Valuing Common Stocks and Stock Warrants provides the following guidance on valuation of acquired entities and goodwill under Section (B) Common Stocks of Subsidiary, Controlled or Affiliated Companies:

(a) Subject to the requirements of Section 5 (B) (b), shares of common stock of an insurance or non-insurance company owned by an insurer, which insurer is either the parent of, or under direct or indirect common control, or affiliated with the issuer of such stock, shall have an Association Value determined on the basis of one of the following bases, provided, however, that such basis and the resultant value are reasonable and appropriate in the circumstances, and provided further that an insurer shall not be required to value the common stock of all its subsidiary, controlled and affiliated companies on the same basis. All of the following valuation bases shall be subject to an adjustment for any reciprocal shareholdings as required by Section 5 (B) (b) (x).

(i) the value of only such of the assets of such company as would constitute lawful investments for the insurer if acquired or held directly by the insurer; or

(ii) subject to the limitations imposed herein and under Section 5 (B) (b) (ix), hereunder, the shares of a non-insurance company may be valued on the basis of the net worth of such company determined in accordance with generally accepted accounting principles, as of the end of its most recent fiscal year, provided, subject to (b) hereof, that the financial statements of the company for its most recent fiscal year have been audited by an independent certified public accountant in accordance with generally accepted auditing standards (the common stock of an insurance company may not be valued under this section); or

(If the common stock of a subsidiary, controlled or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section, such value shall be adjusted to reflect the equity in net assets on a statutory basis with respect to the shares of any underlying insurance company subsidiaries and to reflect the market value appropriately discounted for any underlying company valued using option 5 (B) (a) (v)); or
(iii) book value, defined as in Section 5 (A) (c), provided, however, that the common stock of a non-insurance company may not be valued on the basis of this subsection (iii); or

(iv) subject to the limitations imposed under Section 5 (B) (b) (ix), hereunder, a value equal to the cost of the common stock of such company, provided such value is determined and adjusted to reflect subsequent operating results (1) in the case of insurance companies in accordance with statutory accounting requirements, and (2) for other than insurance companies from an independent certified public accountant audited financial statement prepared in accordance with generally accepted accounting principles; or

(If the common stock of a subsidiary, controlled, or affiliated company is valued on the basis of generally accepted accounting principles in accordance with the provisions of this section the adjustment “to reflect subsequent operating results” shall include net changes in all the capital and surplus accounts on a statutory basis with respect to the shares of any underlying insurance company subsidiaries); or

(v) the market value of the common stock of the company, if the stock is listed on a national securities exchange or entered in the NASDAQ System (other securities traded over-the-counter will not be considered under this section); The share price will be discounted for legal restrictions requiring a registration before any sale may be made and the size and depth of the trading activity in relation to the publicly traded shares outstanding; or

(vi) See Section 3 (C) (2) for valuation of preferred stocks of wholly-owned subsidiaries of insurance companies.

(vii) In applying the provisions of this section to insurers organized in foreign countries, the provisions of Subsection (i) of this section will be applied (based on financial statements for the most recent fiscal year as prepared by an independent certified public accountant), except where special considerations indicate other treatment would be appropriate; or

(viii) any other value that the insurer can substantiate to the satisfaction of the SVO staff as being a reasonable value.

(b) (i) The provisions of Section 5 (B) shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of common stocks of subsidiary, controlled or affiliated companies.

(ii) Not later than April 1 of each year, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Valuation of Securities Task Force, (Task Force), relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for each of its subsidiary, controlled or affiliated companies reported upon in the Annual Statement for the preceding year.

(iii) Within thirty (30) days after the acquisition or formation of a subsidiary, controlled or affiliated company, every insurer shall file with the SVO staff, on the appropriate form prescribed by the Task Force, relevant information identifying, supporting and justifying the value of, and the basis of valuation used in accordance with the provisions of Section 5(B)(a) for such company.
(iv) A valuation basis used for a subsidiary, controlled or affiliated company shall thereafter be consistently applied unless a change is substantiated as reasonable and on that basis is approved in writing by the SVO staff.

(v) If a subsidiary, controlled or affiliated company is valued on the basis of Section 5 (B) (a) (ii) and its books are not audited at the time the valuation is included in the insurer’s annual statement, the insurer shall thereafter report to the SVO staff and explain the difference, if any, between the value of such company as reported in the annual statement and the value as determined by audit. Such report and explanation shall be made as soon as possible following such audit.

(vi) If the common stock of any subsidiary, controlled or affiliated company is valued other than on the basis of market value as defined in Section 5 (B) (a) (v), there shall be deducted from the otherwise determined value a sum equal to the value claimed for any of its assets that would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

(1) are held by the company but used, under a lease arrangement or otherwise, significantly in the conduct of the insurer’s business; or

(2) were acquired from or purchased for the benefit or use of the insurer by the company under circumstances that, in the opinion of the SVO staff, support a finding that the primary purpose of such acquisition was the evasion or avoidance of state laws or regulations pertaining to non-admitted assets.

(vii) The SVO staff may require filings to be by the use of such forms as it prescribes and may requests such supplemental information as it deems desirable. The SVO staff shall utilize the information in such filings and supplemental information to make its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value and shall notify the insurer and its state of domicile of such determination.

(viii) In making its determination as to the reasonableness and appropriateness of the valuation basis and the resultant value for each subsidiary, controlled or affiliated company, the SVO staff shall, among other relevant factors, take into account the following:

(1) the effect of subsidiary valuation on the solvency of the insurer (it being the intent hereof that doubt as to reasonableness shall be resolved by selection of a conservative valuation standard in those circumstances where the higher valuation would make an otherwise insolvent insurer appear solvent);

(2) if the valuation involves acquisition cost, the degree of affiliation between the insurer and the party from whom such company was acquired, the form of the consideration (cash, property, or the exchange of stock), evidence of ability to recover cost, and whether the acquisition price represented the result of arms-length dealing between economic equals; and,

(3) whether revaluation of assets is involved, and the reasonableness thereof.

(ix) With respect to values determined under Sections 5 (B) (a) (ii) and 5 (B) (a) (iv), amounts attributable to goodwill, as defined in (a) hereunder, and other intangibles shall not, except as provided in (b), hereunder, in the aggregate (of all direct and indirect subsidiaries), exceed, (either initially upon the acquisition of a
subsidiary, or thereafter), 10% of the capital and surplus of an insurer, as reported in its next preceding Annual Statement. Such amounts shall, except as provided in (c) and (d), hereunder, be written off over a period not in excess of 10 years, commencing in all cases with the accounting period ending December 31, 1972. (For instructions as to the manner of write-off in certain cases, see (e) and (f), hereunder.)

(a) For the purposes of this section, “goodwill” shall be defined as the amount arising at a given point in time, resulting from an arms-length transaction involving the transfer of a business, representing the difference between the value of the consideration given and the net asset value of the properties acquired on the books of the predecessor company. With respect to insurance company subsidiaries “net asset value” shall mean statutory or annual statement book value. In addition any asset account representing the present value of future contractual or estimated revenue streams will also be deemed goodwill and subject to the limitations of this section.

(b) The limitation with respect to the permissible amount of goodwill shall not apply in the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972.

(c) The write-off period for goodwill in the cases of subsidiaries described in (b), above, may, upon application to and approval by the Securities Valuation Office, be extended to not in excess of 20 years.

(d) Where warranted in exceptional cases, the Securities Valuation Office may require a more rapid write-off of goodwill than is otherwise provided in this section.

(e) In the cases of subsidiaries acquired or under contract to be acquired on or prior to June 14, 1972, an insurer may charge the write-off of goodwill to the common stock component of the Asset Valuation Reserve, where such a reserve exists.

(f) In the cases of subsidiaries acquired after June 14, 1972, amounts of goodwill in excess of 10% of an insurer’s capital and surplus shall be written off immediately by a direct charge to surplus.

23. NAIC Annual Statement Instructions provide the following guidance on the restatement of prior year financial information presented after a merger occurs:

Except in situations where a merger has occurred, amounts reported for assets, liabilities, surplus, revenues, and expenses for prior years in the current year’s annual statement shall be identical to the amounts that were reported in the annual statement of the prior year. However, amounts reported in prior years may need to be adjusted in the current year as a result of the following:

Changes in accounting principles or practices or changes in the methods of applying accounting principles or practices.

Changes in accounting estimates as a result of new events or new information.

Corrections of errors in previously filed information.

A merger.
If changes are required for amounts reported in prior years, such changes should be included in the amounts reported for the current year and the effects of such changes should be reported as follows, unless these instructions or the NAIC Accounting Practices and Procedures manual for Life and Health specifically provide for a different treatment:

(1) The cumulative effect of a change in accounting principles or practices or a change in the method of applying accounting principles or practices should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46). The cumulative effect of changing to a new accounting principle is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods. An example of a change in accounting principles would be a change in the method of accounting for pensions or other post-employment benefits.

(2) The effects of changes in accounting estimates are included in income and expenses in the Summary of Operations for the current year. For example, a change in estimate for reserves for accident and health claims related to prior years should be included in the Summary of Operations in disability benefits and benefits under accident and health policies (Page 4, Line 11) for the current year.

(3) The effects of changes resulting from corrections of errors in previously filed information (for example, mathematical mistakes, misapplication of accounting principles, or oversight or misuse of facts) should be reported as an adjustment to surplus in the current year. Such adjustments to surplus should be reported with an appropriate identifying title as a write-in item for gains and losses in surplus (Page 4, Line 46).

(4) In the case of a merger, prior year's amounts reported for assets, liabilities, surplus, revenues and expenses, as well as those amounts reflected in supporting Annual Statement schedules, should be reported on a merged basis consistent with the current year's post-merger reporting basis. A footnote should be inserted on each page of the Annual Statement which contains such merged amounts clearly detailing the circumstances.

24. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2 provide the following guidance:

The working has been asked to consider whether it is acceptable statutory accounting practice for an insurer to continue to carry an asset for the unamortized goodwill arising from the acquisition of another insurer after the acquired insurer has been merged into the acquiring insurer (former parent)

After considerable discussion, the working group reached a preliminary consensus that continuing to carry unamortized goodwill under such circumstances was not appropriate for statutory purpose and that the unamortized goodwill should have been charged to surplus at the time the acquired insurer was merged with the parent.

After further discussion, the working group agreed to reaffirm the preliminary decision reached in March. In addition, they concluded that the issue of goodwill in general should be referred to the Codification of Statutory Accounting Principles Working Groups for the review of the appropriateness of goodwill for statutory purposes.

25. Individual state insurance laws and regulations vary with respect to requirements for the treatment of goodwill. Many states require goodwill to be nonadmitted. Certain states do allow the admission of goodwill but impose stringent limitations on the amount of goodwill that is considered an admitted asset.
Generally Accepted Accounting Principles

26. GAAP for business combinations is contained in APB 16 which was rejected in its entirety in this issue paper. Rather than repeat APB 16 in the Relevant GAAP Literature Section of this paper a summary of GAAP for Business Combinations from The Current Text - Section B50 - Business Combinations is provided.

BUSINESS COMBINATIONS SECTION B50

Sources: ARB 43, Chapter 1A; ARB 51; APB Opinion 16; AICPA Interpretations of APB Opinion 16; FASB Statement 10; FASB Statement 38; FASB Statement 72; FASB Statement 79; FASB Statement 87; FASB Statement 106; FASB Statement 109; FASB Statement 111; FASB Statement 121; FASB Interpretation 4; FASB Interpretation 9; FASB Technical Bulletin 85-5

B50 Summary

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises. The purchase method and the pooling-of-interests method are both acceptable in accounting for business combinations, although not as alternatives in accounting for the same business combination. This section provides that a business combination shall be accounted for as a pooling of interests if it meets certain specified criteria. Business combinations that do not meet all of the specified criteria shall be accounted for as purchases.

The criteria for the pooling method relate to the attributes of the combining enterprises before the combination, the manner of combining the enterprises, and the absence of certain planned transactions after the combination. The pooling-of-interests method accounts for a business combination as the unifying of the ownership interests of two or more companies by exchange of equity securities. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents. Ownership interests continue and the former bases of accounting shall be retained. The recorded assets and liabilities of the constituents shall be carried forward to the combined corporation at their recorded amounts. Income of the combined corporation shall include income of the constituents for the entire fiscal period in which the combination occurs. The reported income of the constituents for prior periods shall be combined and restated as income of the combined corporation.

The purchase method accounts for a business combination as the acquisition of one enterprise by another. The acquiring corporation shall record at its cost the acquired assets less liabilities assumed. A difference between the cost of an acquired enterprise and the sum of the fair values of tangible and identifiable intangible assets less liabilities assumed shall be recorded as goodwill. The reported income of an acquiring corporation shall include the operations of the acquired enterprise after acquisition, based on the cost to the acquiring corporation.

27. Accounting Principles Board Opinion No. 17, Intangible Assets (APB 17), addresses goodwill and amortization of intangible assets. APB 17 specifies that the amortization period should not exceed 40 years and the straight line method is appropriate unless a company demonstrates that another method is more appropriate. APB 17 also requires companies to perform a subsequent review of amortization to determine if changes should be made in the amortization period:

SUMMARY

1. An enterprise may acquire intangible assets from others or may develop them itself. Many kinds of intangible assets may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability. Both identifiable and unidentifiable assets may be developed internally.
Identifiable intangible assets may be acquired singly, as a part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly. The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset.

2. Accounting for an intangible asset involves the same kinds of problems as accounting for other long-lived assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization), and accounting for that amount if the value declines substantially and permanently. Solving the problems is complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate, and its useful life may be indeterminable.

Conclusions

9. The Board concludes that a company should record as assets the costs of intangible assets acquired from others, including goodwill acquired in a business combination. A company should record as expenses the costs to develop intangible assets which are not specifically identifiable. The Board also concludes that the cost of each type of intangible asset should be amortized by systematic charges to income over the period estimated to be benefited. The period of amortization should not, however, exceed forty years.

28. FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprise an amendment of APB Opinion No. 16 (FAS 38), deals with preacquisition contingencies. Amounts that can be reasonably estimated that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances.

Summary

This Statement specifies how an acquiring enterprise should account for contingencies of an acquired enterprise that were in existence at the purchase date and for subsequent adjustments that result from those contingencies. Amounts that can be reasonably estimated for contingencies that are considered probable are recorded as a part of the allocation of the purchase price. Subsequent adjustments are included in net income when the adjustments are determined except in limited circumstances described in this Statement.

29. FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises (FAS 79), amends APB 16 to eliminate the requirement for nonpublic enterprises to disclose pro forma results of operations for business combinations accounted for by the purchase method:

INTRODUCTION

1. The FASB has undertaken research on financial reporting by private and small public companies to obtain information about the practices and views of managers, financial statement users, and public accountants involved with those companies. A number of participants in those research efforts stated that the requirement to disclose pro forma results of operations for business combinations accounted for by the purchase method was unnecessary and too costly for private companies.

1 Refer to (a) FASB Invitation to Comment, Financial Reporting by Private and Small Public Companies, 1981; (b) FASB Special Report, Financial Reporting by Privately Owned Companies: Summary of Responses to FASB Invitation to Comment, 1983; and (c) FASB Research Report, Financial Reporting by Private Companies: Analysis and Diagnosis, prepared by A. Rashad Abdel-Khalik, 1983.
2. Paragraph 96 of APB Opinion No. 16, Business Combinations, requires an acquiring enterprise to disclose the following information in financial statements of the period in which a business combination accounted for by the purchase method occurs:

   a. Results of operations for the current period as though the enterprises had combined at the beginning of the period, unless the acquisition was at or near the beginning of the period.

   b. Results of operations for the immediately preceding period as though the enterprises had combined at the beginning of that period if comparative financial statements are presented.

3. The Board has concluded that the disclosures prescribed by paragraph 96 of Opinion 16 should not be required in the financial statements of nonpublic enterprises. The basis for the Board’s conclusions is presented in the appendix to this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

4. Disclosures of pro forma results of operations prescribed in paragraph 96 of Opinion 16 for business combinations accounted for by the purchase method are not required for nonpublic enterprises.

5. For purposes of this Statement, a nonpublic enterprise is an enterprise other than one (a) whose debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally), or (b) whose financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

Amendment to APB Opinion No. 16

6. The following footnote is added to the end of paragraph 96 of Opinion 16:

   * The disclosures prescribed by paragraph 96 are not required in the financial statements of nonpublic enterprises as defined by FASB Statement No. 79, Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises.

Effective Date

7. This Statement shall be effective for financial statements for fiscal years beginning after December 15, 1983. Earlier application is permitted in financial statements that have not previously been issued.

30. GAAP literature is silent on push-down basis of accounting, although it was raised by the FASB in a 1976 Discussion Memorandum on business combinations. The FASB has included the issue of pushdown in the New Basis Accounting part of its Consolidations and Related Matters project. The SEC staff’s views regarding the application of pushdown accounting are discussed Staff Accounting Bulletin Topic 5J. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned, should establish a new basis of accounting for the purchased assets and liabilities which should be reflected in the acquired entity’s separate financial statements. In circumstances where outside interest in the form of minority stockholders, or holders of public debt or preferred stock remain, the staff would encourage but generally not insist on the application of pushdown accounting.

31. FASB Statement No 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, provides the following guidance with respect to the impairment of goodwill.
Goodwill

12. If an asset being tested for recoverability was acquired in a business combination accounted for using the purchase method, the goodwill that arose in that transaction shall be included as part of the asset grouping (paragraph 8) in determining recoverability. If some but not all of the assets acquired in that transaction are being tested, goodwill shall be allocated to the assets being tested for recoverability on a pro rata basis using the relative fair values of the long-lived assets and identifiable intangibles acquired at the acquisition date unless there is evidence to suggest that some other method of associating the goodwill with those assets is more appropriate. In instances where goodwill is identified with assets that are subject to an impairment loss, the carrying amount of the identified goodwill shall be eliminated before making any reduction of the carrying amounts of impaired long-lived assets and identifiable intangibles.

Reporting and Disclosure

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement and in the statement of activities of a not-for-profit organization. Although there is no requirement to report a subtotal such as “income from operations,” entities that present such a subtotal must include the impairment loss in that subtotal.

14. An entity that recognizes an impairment loss shall disclose all of the following in financial statements that include the period of the impairment write-down:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment
   b. The amount of the impairment loss and how fair value was determined
   c. The caption in the income statement or the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement
   d. If applicable, the business segment(s) affected.

32. FASB Emerging Issues Task Force Issue No. 95-19, Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination provides the following guidance.

ISSUE

Opinion 16 appears to include contradictory guidance about the date that should be used to value equity securities issued to effect a business combination accounted for using the purchase method. Paragraph 74 of Opinion 16 states that “the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in determining the fair value of securities issued.” On the other hand, paragraph 94 of Opinion 16 refers to determining the cost of an acquired company as of the date of acquisition, which is defined in paragraph 93 as, “ordinarily . . . the date assets are received and other assets are given or securities are issued.” This Issue addresses that apparent contradiction.

The interval between initiating and completing a business combination may involve an extended period of time. Although management of the companies involved may agree to and announce the terms of a business combination at the initiation date, internal or external contingencies, such as the need to obtain shareholder or regulatory approvals, may exist and prevent concurrent consummation of the combination. Because of the length of time that may be required to resolve those contingencies, the market price of the securities that are expected to be issued to effect a purchase business combination may fluctuate. As a result, the total cost of the acquired company assigned by the acquirer may vary significantly depending on the date that is used to value the securities that are issued.
The issue is what date should be used to value marketable equity securities issued to effect a business combination accounted for using the purchase method.

EITF DISCUSSION

The Task Force reached a consensus that the value of marketable equity securities issued to effect a purchase business combination should be determined, pursuant to the guidance in paragraph 74 of Opinion 16, based on the market price of the securities over a reasonable period of time before and after the two companies have reached agreement on the purchase price and the proposed transaction is announced. In other words, the date of measurement of the value of the marketable equity securities should not be influenced by the need to obtain shareholder or regulatory approvals. Task Force members observed that the reasonable period of time referred to in paragraph 74 of Opinion 16 is intended to be very short, such as a few days before and after the acquisition is agreed to and announced. Task Force members also observed that in transactions involving a hostile tender offer, the measurement date for the value of the marketable equity securities occurs when the proposed transaction is announced and sufficient shares have been tendered to make the offer binding or when the proposed acquisition becomes nonhostile, as evidenced by the target company’s agreement to the purchase price.

The Task Force also reached a consensus that if the purchase price (the number of shares or other consideration) is subsequently changed, a new measurement date for valuing the marketable equity securities that will be issued to effect the combination is established as of the date of the change. Task Force members observed that a change to the purchase price may result from further negotiations or from changes in the market price of the equity securities causing, perhaps pursuant to the initial agreement, a change in the security’s exchange ratio or in a cash component of the purchase price.

The Task Force reached a consensus that the consensuses described in this Issue should only be applied prospectively to purchase business combinations consummated after November 16, 1995.

OTHER SOURCES OF INFORMATION

33. The draft discussion material from previous Life codification project provides the following guidance on mergers in the Introduction section under Accounting for Assets Transferred Between Affiliates:

A merger or consolidation of insurance companies under common control is to be recorded at book value. The combined surplus should not be enhanced or reduced as a result of the restructuring. A bulk reinsurance agreement of all the business where substantially all of the assets and substantially all of the liabilities are transferred in order to create a shell is to be considered a merger or consolidation for purposes of this section.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 6, Investments in Subsidiaries, Controlled or Affiliated Companies
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 6, Investments in Subsidiaries, Controlled or Affiliated Companies
- Purposes and Procedures of the Securities Valuation Office of the National Association of Insurance Commissioners
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force Issue No. 94-1 and 94-2
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairment of Assets
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities
- Issue Paper No. 48 - Investments in Joint Ventures, Partnerships and Limited Liability Companies

**Generally Accepted Accounting Principles**
- FASB Statement No 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
- FASB Emerging Issues Task Force Issue No. 95-19, *Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination*

**Rejected Herein**
- Accounting Principles Board Opinion No. 16, *Business Combinations*
- Accounting Principles Board Opinion No. 17, *Intangible Assets*
- FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*
- FASB Statement No. 79, *Elimination of Certain Disclosures for Business Combinations by Nonpublic Enterprises*

**Related and Interpretive Literature Also Rejected Herein**
- AICPA Accounting Interpretations, Business Combinations: Accounting Interpretations of *Accounting Principles Board Opinion No. 16*
- FASB Statement No. 10, *Extension of “Grandfather” Provisions for Business Combinations*
- AICPA Accounting Interpretations, Intangible Assets: Unofficial Accounting Interpretations of *Accounting Principles Board Opinion No. 17*
- FASB Emerging Issues Task Force No. 85-14, *Securities That Can Be Acquired for Cash in a Pooling of Interests*
- FASB Emerging Issues Task Force No. 86-9, *IRC Section 338 and Push-Down Accounting*
- FASB Emerging Issues Task Force No. 86-10, *Pooling with 10 Percent Cash Payout Determined by Lottery*
- FASB Emerging Issues Task Force No. 87-11, *Allocation of Purchase Price to Assets to Be Sold*
- FASB Emerging Issues Task Force No. 87-15, *Effect of a Standstill Agreement on Pooling-of-Interests Accounting*
- FASB Emerging Issues Task Force No. 87-16, *Whether the 90 Percent Test for a Pooling of Interests Is Applied Separately to Each Company or on a Combined Basis*
- FASB Emerging Issues Task Force Issue No. 87-27, *Pools of Companies that Do Not Have a Controlling Class of Common Stock*
- FASB Emerging Issues Task Force Issue No. 88-26, *Controlling Preferred Stock in a Pooling of Interests*
- FASB Emerging Issues Task Force Issue No. 88-27, *Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations*
- FASB Emerging Issues Task Force Issue No. 89-7, *Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity*
- FASB Emerging Issues Task Force Issue No. 90-5, *Exchanges of Ownership Interest between Entities under Common Control*
- FASB Emerging Issues Task Force No. 90-6, *Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold*
- FASB Emerging Issues Task Force No. 90-12, *Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16*
- FASB Emerging Issues Task Force No. 90-13, *Accounting for Simultaneous Common Control Mergers*
- FASB Emerging Issues Task Force No. 91-5, *Nonmonetary Exchange of Cost-Method Investments*
- FASB Emerging Issues Task Force Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*
- FASB Emerging Issues Task Force No. 93-7, *Uncertainties Related to Income Taxes in a Purchase Business Combination*
- FASB Emerging Issues Task Force No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*
- FASB Emerging Issues Task Force No. 95-8, *Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination*
- FASB Emerging Issues Task Force No. 95-12, *Pooling of Interests with a Common Interest in a Joint Venture*
- FASB Emerging Issues Task Force No. 95-14, *Recognition of Liabilities in Anticipation of a Business Combination*
- FASB Emerging Issues Task Force No. 96-8, *Accounting for a Business Combination When the Issuing Company Has Targeted Stock*
- FASB Technical Bulletin 85-5, *Issues Related to Accounting for Business Combinations*

**State Regulations**
- Indiana Insurance Statutes Title 27, Article 1, Chapter 12, *Life Insurance Company Powers and Policy Requirements*
- Indiana Insurance Statutes Title 27, Article 1, Chapter 13, *Casualty, Fire and Marine Insurance Company Powers and Policy Requirements*
- Pennsylvania Advance Laws to the Insurance Code, *Act 8--SB701*

**Other Sources of Information**
- Draft discussion material from previous Life Codification projects.
Financial Guaranty Insurance

SUMMARY OF ISSUE

1. Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental body, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general. Financial guaranty insurance does not provide protection from losses which occur due to fortuitous physical events, failure or deficiency in the operation of equipment, or the inability to extract natural resources. Additionally, it does not provide coverage from losses related to various types of bonds (e.g., individual or schedule public official bond; a contract bond; a court bond), credit insurance, guaranteed investment contracts, and residual value insurance.


3. GAAP guidance for insurance contracts is provided by FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), however, FAS 60 does not contain guidance that is specific to financial guaranty insurance contracts. Under GAAP, premiums are generally earned in proportion to the amortization of the insured principal over the term of each insured debt obligation.

4. The purpose of this issue paper is to establish statutory accounting principles for the recording and recognition of premium revenue and unpaid losses, losses, and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition

5. Written premium shall be recorded in accordance with Issue Paper No. 53 - Property Casualty Contracts - Premiums.

6. When premiums are paid on the installment basis, premium revenue shall be recognized in the statement of operations using the monthly pro-rata method. Premiums not paid on the installment basis shall be recognized in the statement of operations in proportion with the amount and expected coverage period of the insured risk.

7. When the anticipated losses, loss adjustment expenses, and maintenance cost exceed the recorded unearned premium reserve and contingency reserve, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since
they have previously been expensed. If an entity utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the notes to the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition
8. Unpaid losses and loss adjustment expenses shall be recognized in accordance with Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55). Each financial guaranty insurer shall establish and maintain reserves for unpaid losses and loss adjustment expenses. The initial date of default shall be considered the incident which gives rise to a claim. Such method shall be used to determine loss reserves, which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the financial guaranty insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year. In addition, a reserve component for incurred but not reported claims shall be reasonably estimated if deemed necessary by the financial guaranty insurer or required by the commissioner following an examination or actuarial analysis.

Contingency Reserve
9. In addition to the unearned premium reserve and the liability established for unpaid losses and loss adjustment expenses, financial guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction.

10. The contingency reserve required shall be the greater of fifty percent of premiums written for each category or the amount provided by applying the following percentages to the principal guaranteed in each calendar year. The premiums written shall be net of reinsurance if the reinsurer has established a contingency reserve.

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal obligation bonds</td>
<td>0.55 percent</td>
</tr>
<tr>
<td>Special revenue bonds</td>
<td>0.85 percent</td>
</tr>
<tr>
<td>Investment grade Industrial Development Bonds (IDBs)</td>
<td>1.00 percent</td>
</tr>
<tr>
<td>secured by collateral or having a term of seven years or less, and utility first mortgage obligations</td>
<td></td>
</tr>
<tr>
<td>Other investment grade IDBs</td>
<td>1.50 percent</td>
</tr>
<tr>
<td>Other IDBs</td>
<td>2.50 percent</td>
</tr>
<tr>
<td>Investment grade obligations, secured by collateral or having a term of seven years or less</td>
<td>1.00 percent</td>
</tr>
<tr>
<td>Other investment grade obligations</td>
<td>1.50 percent</td>
</tr>
<tr>
<td>Non-investment grade consumer debt obligations</td>
<td>2.00 percent</td>
</tr>
<tr>
<td>Non-investment grade assetbacked securities</td>
<td>2.00 percent</td>
</tr>
<tr>
<td>All other non-investment grade obligations</td>
<td>2.50 percent</td>
</tr>
</tbody>
</table>

11. Additions to the reserve for items a. through e. in paragraph 10 above shall be equal to the greater of one-eighthieth of the amounts derived by applying the appropriate contribution specified above shall be made each quarter for a period of twenty (20) years. Additions to the reserve for items f through j. in paragraph 10 above shall be equal to the greater of one-sixtieth of the amounts derived by applying the appropriate contribution specified shall be made each quarter for a period of fifteen (15) years.

12. For contingency reserves required to maintained for 20 years, contributions may be discontinued if the total reserve established for all categories in subparagraphs 10 a. through 10 e. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed. For contingency reserves required to maintained for 15 years, contributions may be discontinued if the total reserve established for all categories in subparagraphs 10 f. through 10 j. exceeds the sum of the percentages contained therein multiplied by the unpaid principal guaranteed.
13. The contingency reserve may also be released in the following circumstances:

a. For contingency reserves required to be maintained for 20 years:
   i. in any year in which actual incurred losses exceed 35% of the corresponding earned premiums, with commissioner approval;
   ii. if the reserve has been in existence less than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer’s financial guarantees, with commissioner approval;
   iii. if the reserve has been in existence more than 40 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer’s financial guarantees, upon 30 days prior written notice to the commissioner.

b. For contingency reserves required to be maintained for 15 years:
   i. in any year in which actual incurred losses exceed 65% of the corresponding earned premiums, with commissioner approval;
   ii. if the reserve has been in existence less than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer’s financial guarantees, with commissioner approval;
   iii. if the reserve has been in existence more than 30 quarters, upon demonstration that the amount is excessive in relation to the outstanding obligations under the insurer’s financial guarantees, upon 30 days prior written notice to the commissioner.

Any reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded through surplus.

Disclosures
14. Financial guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55 and Issue Paper No. 77 - Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.

DISCUSSION
15. This issue paper rejects current statutory guidance set forth in the Financial Guaranty Insurance Model Act. However, some of the circumstances that allow a reporting entity to reduce its contingency reserves in the model were adopted in this issue paper. One of these circumstances provide that the reduction is allowed if it is approved by the commissioner. Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive. This issue paper is generally consistent with statutes adopted in New York with modifications to require an IBNR reserve in certain situations and recognition of a premium deficiency in certain instances as described in paragraph 7. The requirement to record a deficiency reserve was made for consistency with the requirements of Issue Paper No. 55. Additionally, this issue paper expands current statutory guidance by utilizing principal guaranteed to determine a maximum required contingency reserve.

16. The contingency reserve does not meet the definition of a liability which is set forth in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. However, it is consistent with the “ultimate objective of solvency regulations” as stated in the Statement of Concepts. This states,
the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

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

17. This issue paper is inconsistent with GAAP in that GAAP requires all premiums to be recognized in the statement of operations in a manner consistent with the expiration of the insured risk. This issue paper requires installment billings to be recognized in operations using the monthly pro-rata method. FAS 60 was rejected in Issue Paper No. 50 - Definitions and Classifications of Insurance or Managed Care Contracts In Force.

18. Discounting the liability established for unpaid claims, losses and loss adjustment expenses is consistent with Issue Paper No. 65 - Property Casualty Contracts because the payments to be made for losses incurred with respect to insured events are generally fixed and determinable once the insured event has occurred.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

19. The Financial Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts are included)

Section 1. Definitions

A. As used in this article:

(1) Financial guaranty insurance means a surety bond, insurance policy or, when issued by an insurer, an indemnity contract and any guaranty similar to the foregoing types, under which loss is payable upon proof of occurrence of financial loss to an insured claimant, obligee or indemnity as a result of any of the following events:

(a) Failure of any obligor on any debt instrument or other monetary obligation (including common or preferred stock guarantied under a surety bond, insurance policy or indemnity contract) to pay when due principal, interest, premium, dividend or purchase price of or on the instrument or obligation, when the failure is the result of a financial default or insolvency, regardless of whether the obligation is incurred directly or as guarantor by or on behalf of another obligor that has also defaulted;

(b) Changes in the levels of interest rates, whether short or long term, or the differential in interest rates between various markets or products;

(c) Changes in the rate of exchange of currency;
(d) Inconvertibility of one currency into another for any reason, or inability to withdraw funds held in a foreign country resulting from restrictions imposed by a governmental authority;

(e) Changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general; or

(f) Other events which the commissioner determines are substantially similar to any of the foregoing.

(2) Notwithstanding Paragraph (1) of this subsection, financial guaranty insurance shall not include:

(a) Insurance of any loss resulting from any event described in Subsection A(1) of this section, if the loss is payable only upon the occurrence of any of the following, as specified in a surety bond, insurance policy or indemnity contract:

(i) A fortuitous physical event;

(ii) A failure of or deficiency in the operation of equipment; or

(iii) An inability to extract or recover a natural resource;

(b) An individual or schedule public official bond;

(c) A contract bond, including bid, payment or maintenance bond, or a performance bond where the bond is guarantying the execution of a contract other than a contract of indebtedness or other monetary obligation;

(d) A court bond required in connection with judicial, probate, bankruptcy or equity proceedings, including waiver, probate, open estate and life tenant bond;

(e) A bond running to the federal, state, county, municipal government or other political subdivision, as a condition precedent to granting of a license to engage in a particular business or of a permit to exercise a particular privilege;

(f) A loss security bond or utility payment indemnity bond running to a governmental unit, railroad or charitable organization;

(g) A lease, purchase and sale or concessionaire surety bond;

(h) Credit unemployment insurance, meaning insurance on a debtor in connection with a specific loan or other credit transaction, to provide payments to a creditor in the event of unemployment of the debtor for the installments or other periodic payments becoming due while a debtor is unemployed;

Drafting Note: Subparagraph (h) is to be used by states which do not authorize credit unemployment insurance as a separate line of business but do permit this line to be written.

(i) Credit insurance, meaning insurance indemnifying manufacturers, merchants or educational institutions extending credit against loss or damage resulting from nonpayment of
debts owed to them for goods or services provided in the normal course of their business;

(j) Guaranteed investment contracts issued by life insurance companies which provide that the life insurer itself will make specified payments in exchange for specific premiums or contributions;

(k) Residual value insurance authorized by Section [insert section];

(l) Mortgage guaranty insurance authorized by Section [insert section];

(m) Indemnity contracts or similar guaranties, to the extent that they are not otherwise limited or proscribed by this chapter, in which a life insurer:

(i) Guaranties its obligations or indebtedness or the obligations or indebtedness of a subsidiary (as defined in Section [insert section]) other than a financial guaranty insurance corporation; provided that:

(I) To the extent that any such obligations or indebtedness are backed by specific assets, the assets must at all times be owned by the insurer or the subsidiary; and

(II) In the case of the guaranty of the obligations or indebtedness of the subsidiary that are not backed by specific assets of the life insurer, the guaranty terminates once the subsidiary ceases to be a subsidiary; or

(ii) Guaranties obligations or indebtedness (including the obligation to substitute assets where appropriate) with respect to specific assets acquired by a life insurer in the course of normal investment activities and not for the purpose of resale with credit enhancement, or guaranties obligations or indebtedness acquired by its subsidiary, provided that the assets acquired pursuant to this item (ii) have been:

(I) Acquired by a special purpose entity, whose sole purpose is to acquire specific assets of the life insurer or the subsidiary and issue securities or participation certificates backed by such assets; or

(II) Sold to an independent third party; or

(iii) Guaranties obligations or indebtedness of an employee or agent of the life insurer; or

(n) Any other form of insurance covering risks which the commissioner determines to be substantially similar to any of the foregoing.
Section 2. Organization; Financial Requirements

(A) A financial guaranty insurance corporation may be organized and licensed in the manner prescribed in Section [insert section], except as modified by the following provisions:

(1) A corporation organized for the purpose of transacting financial guaranty insurance may, subject to all the applicable provisions of this chapter, be licensed to transact the following additional kinds of insurance:

(a) Residual value insurance, as authorized by Section [insert section];

(b) Surety insurance, as authorized by Section [insert section]; and

(c) Credit insurance, as authorized by Section [insert section].

(2) A corporation may only assume those lines of insurance for which it is licensed to write direct business.

(3) Prior to the issuance of a license, a corporation shall submit for the approval of the commissioner a plan of operation detailing the types and projected diversification of guaranties that will be issued, the underwriting procedures that will be followed, managerial oversight methods, investment policies and such other matters as may be prescribed by the commissioner.

(4) A financial guaranty corporation shall be subject to all of the provisions of this chapter applicable to property and casualty insurers to the extent that the provisions are not inconsistent with the provisions of this Act.

(5) A financial guaranty insurance corporation's investments in any one entity insured by that corporation shall not exceed one percent of its admitted assets as of the end of the prior calendar year.

(B) A financial guaranty corporation shall not transact business unless:

(1) It has paid-in capital of at least $10 million and paid-in surplus of at least $40 million, and shall at all times thereafter maintain a minimum surplus to policyholders of $35 million;

(2) It establishes a contingency reserve, net of reinsurance, as follows:

(a) The contributions to the reserve shall be calculated by applying the following percentages to the net principal written each calendar year of guaranties of:

(i) Municipal obligation bonds, 0.8 percent;

(ii) Special revenue bonds, 1.2 percent;

(iii) Industrial development bonds, 1.6 percent;

(iv) Secured investment grade obligations, 1.6 percent;

(v) Investment grade obligations not secured, 2.5 percent; and

(vi) All other obligations guarantied, 3.0 percent.
(b) (i) Quarterly additions to the reserve for Items (i), (ii) and (iii) of Subparagraph (a) above shall be equal to the greater of one-eightieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of twenty (20) years; and

(ii) Quarterly additions to the reserve for Items (iv), (v) and (vi) of Subparagraph (a) above shall be equal to the greater of one-fortieth of the amounts derived by applying the appropriate contribution specified in Subparagraph (a) or fifty percent (50%) of the quarterly earned premiums on such guaranties and shall be maintained for a period of ten (10) years.

(c) The reserve may be released thereafter in the same manner, except that a part of the reserve may be released proportional to the reduction in net total liabilities resulting from reinsurance and the reinsurer shall, on the effective date of the reinsurance, establish a reserve in an amount equal to the amount released.

(d) Withdrawals from the contingency reserve, to the extent of any excess, may be made from the earliest contributions to the reserve remaining:

(i) With the approval of the commissioner, in any year in which the actual incurred losses exceed thirty-five percent (35%) of earned premiums, or

(ii) Upon thirty (30) days prior notice to the commissioner, provided that the contingency reserve has been in existence for forty (40) quarters, for reserves subject to Item (i) of Subparagraph (b) of this paragraph, and twenty (20) quarters, for reserves subject to Item (ii) of Subparagraph (b) of this section, upon demonstration that the amount carried is excessive in relation to the corporations outstanding obligations.

(3) In addition to the contingency reserve, the case basis method or other method as may be prescribed by the commissioner shall be used to determine loss reserves, in a manner consistent with Section [insert section], which shall include a reserve for claims reported and unpaid net of collateral. A deduction from loss reserves shall be allowed for the time value of money by application of a discount rate equal to the average rate of return on the admitted assets of the insurer as of the date of the computation of the reserve. The discount rate shall be adjusted at the end of each calendar year.

(4) It shall maintain an unearned premium reserve, net of reinsurance, computed on the monthly pro rata basis, where premiums are paid on an installment basis. All other such premiums paid shall be earned proportionately with the expiration of exposure, or by such other method as the commissioner may prescribe or approve.

Generally Accepted Accounting Principles
20. FAS 60 provides the following guidance with respect to revenue recognition:
9. Premiums from short-duration insurance contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. A liability for unpaid claims (including estimates of costs for claims relating to insured events that have occurred but have not been reported to the insurer) and a liability for claim adjustment expenses shall be accrued when insured events occur.

13. Premiums from short-duration contracts ordinarily shall be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

Premium Deficiency

32. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts. Insurance contracts shall be grouped consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists.

Short-Duration Contracts

33. A premium deficiency shall be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums.

34. A premium deficiency shall first be recognized by charging any unamortized acquisition costs to expense to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortized acquisition costs, a liability shall be accrued for the excess deficiency.

RELEVANT LITERATURE

Statutory Accounting
- The Financial Guaranty Insurance Model Act
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 53 - Property Casualty Contracts - Premiums
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65 - Property and Casualty Contracts
- Issue Paper No. 77 - Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises

State Regulations
- Chapter 28, Article 69 of New York Statutes - Insurance Laws
- Chapter 1, Article 5 of California Statutes - Insurance Laws
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Statutory Issue Paper No. 71

Policy Acquisition Costs and Commissions

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Current statutory guidance on the accounting for policy acquisition costs and commissions is contained in Chapters 8 and 18 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapters 8, 17, and 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies. Under this current guidance, policy acquisition costs and commissions are expensed as incurred.

2. GAAP guidance on the accounting for acquisition costs is primarily contained in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60) and FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments (FAS 97). Under GAAP accounting, policy acquisition costs and commissions are deferred and amortized to income.

3. The purpose of this issue paper is to establish statutory accounting principles for policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

5. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported.

6. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. These transactions are, in fact, funding agreements between a reporting entity and a third party. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the
persistence of the policy, the continuance of the premium payment or the maintenance of the agent’s license with the reporting entity is not maintained with respect to the payment stream.

7. The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

DISCUSSION

8. This issue paper maintains the current statutory accounting for policy acquisition costs and commissions which differs from GAAP. GAAP accounting for policy acquisition costs and commissions is driven by the objective of matching revenues and expenses, therefore these costs are deferred and amortized to income as the related premium is recognized as revenue for FAS 60 products or in proportion to estimated gross profits for FAS 97 products. The primary objective of statutory accounting is to measure solvency. The guidance adopted in this paper is consistent with the Statement of Concepts which states:

Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

9. The statutory accounting principles established in this issue paper are consistent with Issue Paper No. 50 - Definitions and Classifications of Insurance Contracts which rejects FAS 60 and FAS 97.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on levelized commissions:

Levelized Commission

The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.

These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents would ultimately be repaid (with interest explicit or implied) to the third party by “levelized” payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the insurer. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.

The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency but rather are linked to the repayment of an advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.
11. Chapter 18, Commissions, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains the following guidance on commissions:

Financial statements should not reflect paid or incurred commissions on an earned premium basis, except for commissions based on loss experience. If commissions by contract are paid on an earned premium basis, but are not dependent on the loss experience of the insurance written, a reserve should be established for unpaid commissions. This reserve shall also be offset against “Agents’ Balances or Uncollected Premiums”.

Commissions payable on reinsurance assumed business should be included as an offset to “Agents’ Balances or Uncollected Premiums”. Commissions receivable on reinsurance ceded business should be included as an offset to “Ceded Reinsurance Balances Payable”, which are included in “Agents’ Balances or Uncollected Premiums”.

Contingent Commission

Some insurance companies, to encourage quantity and quality of production, or to penetrate a line of business or geographical area, will enter into special commission arrangements with some of their agents. The incentive for the selection of good risks is that the agent is allowed to share in the profitability of the insurance he produces. The terms of the arrangement usually will be set forth in a “contingency commission agreement”, which is either incorporated as part of the agency contract or as a separate contract. The agreement will provide for the dates upon which accountings are to be rendered to determine the contingent commissions, items to be included in the calculation, and a provision for the calculation, if any, in the event the contract is canceled.

The determination of the contingent commission liability is based upon the terms of the commission agreement. If the contract specifies that commissions will be determined on the basis of a formula that relates to loss experience, a commission liability must be established for the earned portion. The unpaid liability for commissions that are based upon loss experience should be included in a separate liability heading - “Contingent Commissions and Other Similar Charges”.

Some agency contracts provide for vesting of the agents’ commissions for renewals or policy adjustments. The contract also may specify that the company will pay the agent for the commutation of commissions payable on future premium collections. Such payments must be included as a commission expense. If the company has incurred a liability to commutate an agent’s commission at the balance sheet date, the liability should be included as an offset to “Agents’ Balances or Uncollected Premiums”.

12. Chapter 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on commissions:

Commission Incurred

Except for commissions on deferred and uncollected life insurance premiums, commissions are generally recognized as incurred in the Summary of Operations when it is probable that they will become payable.

13. Chapter 19 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapter 20 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies simply address the classification of expenses; therefore, there is no explicit guidance for taxes, licenses and fees and general expenses.

14. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance:
In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.

**Generally Accepted Accounting Principles**

15. Statement of Accounting Concepts No. 6 establishes the following definition of an asset:

26. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

16. FAS 60 contains the following guidance on the accounting for acquisition costs:

28. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.

29. Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as an asset.

30. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, shall be applied to applicable unearned premiums throughout the period of the contracts.

31. Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

17. The guidance in FAS 60 was modified by FAS 97 as follows:

22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.

23. Estimated gross profit, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:

   a. Amounts expected to be assessed for mortality (sometimes referred to as the cost of insurance) less benefit claims in excess of related policyholder balances

   b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)
c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances

d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)

e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 17 - Other Liabilities, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 18 - Commissions
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles
- FASB Statement of Accounting Concepts No. 6, Elements of Financial Statements
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 72

Statutory Surplus

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for capital stock, paid-in or contributed surplus and organizational surplus, and unassigned surplus is provided in Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, and Chapter 25, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and in Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus and Chapter 28, Unassigned Funds (Surplus) of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP does not provide specific guidance on surplus but rather provides guidance on shareholders’ equity which encompasses capital stock, additional paid in capital and retained earnings. The AICPA Audit and Accounting Guide: Stock Life Insurance Companies (AICPA Life Audit and Accounting Guide) and the AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies (AICPA P&C Audit and Accounting Guide) contain several references to surplus, however, they do not provide specific guidance on surplus.

3. The purpose of this issue paper is to establish statutory accounting principles for statutory surplus that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Statutory surplus of a reporting entity consists of the following:
   a. capital stock;
   b. treasury stock;
   c. gross paid-in and contributed surplus;
   d. surplus notes;
   e. unassigned funds (surplus);
   f. special surplus funds;
   g. other than special surplus funds;

Capital Stock
5. The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a “stated value” and record
such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus.

6. Notes or other receivables received for the issuance of capital stock satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with Issue Paper No. 9 - Subsequent Events (Issue Paper No. 9) and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

Treasury Stock
7. Treasury stock is capital stock that has been issued and subsequently reacquired by the reporting entity. It is held for either reissuance or cancellation in the future. When a reporting entity’s stock is acquired for purposes other than retirement, or when ultimate disposition has not yet been decided, the cost of acquired stock shall be reported as treasury stock which reduces statutory surplus. The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid up capital shown in the capital stock account. Cancellation of treasury stock shall reduce the capital stock account by the par value or stated value and reduce paid-in or contributed surplus by the excess of cost over par value or stated value.

Gross Paid-in and Contributed Surplus
8. Gross paid-in and contributed surplus is the amount of capital received in excess of the par value of the stock issued. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Forgiveness of a reporting entity’s obligations to its parent or other stockholders shall be accounted for as contributed surplus.

9. Notes or other receivables received as additional capital contributions satisfied by receipt of cash or readily marketable securities prior to the filing of the annual statement shall be treated as a Type I subsequent event in accordance with Issue Paper No. 9 and as such shall be considered an admitted asset based on the evidence of collection and approval of the domiciliary commissioner. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted.

10. Real estate or other assets received as additional capital contributions are nonreciprocal transfers as defined in Issue Paper No. 73 - Nonmonetary Transactions.

11. Stock purchase warrants issued in return for cash shall be credited to gross paid-in and contributed surplus. When debt instruments are issued with conversion features, no value shall be assigned to the conversion features unless the conversion feature is clearly separable from the debt obligation in the form of a detachable stock purchase warrant. In such instances the relative fair value of the detachable stock purchase warrant at time of issue shall be credited to gross paid-in and contributed surplus.

Surplus Notes
12. Surplus notes are financial instruments that are subject to strict control by the commissioner of the reporting entity’s state of domicile and have been approved by the commissioner as to form and content. These instruments are commonly referred to as surplus notes but are also referred to as surplus debentures or contribution certificates. Issue Paper No. 41 - Surplus Notes (Issue Paper No. 41) provides the specific characteristics of surplus notes and provides accounting guidance for surplus notes. Only notes meeting the requirements of Issue Paper No. 41 shall be accounted for as surplus notes.
Unassigned Funds (Surplus)

13. Unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. Certain components of unassigned funds (surplus) are addressed in more detail in other issue papers. Unassigned funds (surplus) is comprised of:

a. **Net Income**
   Net income resulting from insurance and other operating activities of the reporting entity since its inception.

b. **Unrealized Capital Gains and Losses on Investments**
   The cumulative unrealized capital gain or loss that results from differences between the prescribed statement value of investments carried at market value and the cost of those investments is a component of unassigned funds (surplus). This component changes as periodic unrealized gains and losses are credited or charged directly to unassigned funds (surplus).

c. **Effect of Exchange Rate Fluctuations**
   The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation are recorded as unrealized capital gains and losses and therefore are a component of unassigned funds (surplus). This component changes as the exchange rates fluctuate.

d. **Nonadmitted Assets**
   The nonadmitted values of assets owned by a reporting entity are a reduction of unassigned funds (surplus). This component of unassigned funds (surplus) changes as nonadmitted asset values change. Changes in nonadmitted asset values are charged or credited directly to unassigned funds (surplus).

e. **Provision for Reinsurance**
   A reporting entity must establish a statutory liability, provision for reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and certain overdue balances from authorized reinsurers. The liability is charged directly to unassigned funds (surplus). Therefore, at any point in time there is a reduction of unassigned funds (surplus) equal to a reporting entity’s liability for unauthorized reinsurance.

f. **Asset Valuation Reserves**
   Where an Asset Valuation Reserve is required to be recorded as a statutory liability, there is a reduction of unassigned funds (surplus) in an amount equal to the liability. Changes to the Asset Valuation Reserve are charged or credited directly to unassigned funds (surplus).

g. **Separate Accounts**
   A life insurer’s balance sheet includes the total assets and liabilities of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Changes in the surplus of the separate accounts business of an insurer are charged or credited directly to unassigned funds (surplus).

h. **Subscribers Savings Accounts**
   Subscribers Savings Accounts (SSA) are unique to reciprocals. SSAs represent a portion of a reciprocal insurance company’s surplus that has been identified as subscribers (policyholders) accounts. When the source of amounts credited to the subscriber accounts is from the reciprocal’s operations, the amounts are reported as unassigned funds (surplus).
i. **Dividends to Stockholders**
Dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair market value of the assets distributed if it is property dividend, or the par value of the company’s stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus while other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders shall be accounted for as a dividend. Dividends paid to related parties are subject to the requirements of Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

j. **Change in Accounting Principles**
The effects of a change in accounting principle or the application of an accounting principle, such as a change in reserve account because of a change in valuation basis, are reported as a charge or credit to unassigned funds (surplus). The effect of these changes shall not be included in the determination of net income or loss.

k. **Correction of an Error**
Corrections of errors in previously reported financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors shall not be included in the determination of net income or loss.

l. **Stock Issuance Expenses**
Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees are charged to unassigned funds (surplus).

m. **Change in Surplus as a Result of Reinsurance**
Life and accident and health insurers report increases in surplus that result from certain types of reinsurance transactions on a net of tax basis. As profits emerge from the ceded business the increase in surplus is amortized to income as described in paragraph 39.

n. **Changes in Deferred Tax Assets and Deferred Tax Liabilities**
Consistent with the conclusions reached in Issue Paper No. 83 - Accounting for Income Taxes, changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of unassigned funds (surplus).

o. **Other**
This category includes other gains and losses in surplus not specifically identified elsewhere in this issue paper including but not limited to; net proceeds from life insurance on employees and unearned compensation relating to stock issuances made under compensatory Employee Stock Ownership Plans, Stock Option Plans and Stock Purchase Plans.

**Special Surplus Funds**
14. A reporting entity may establish a segregated surplus account to provide for contingencies. Surplus thus appropriated is called appropriated surplus or special surplus funds. Surplus resulting from any retroactive reinsurance transaction entered by a property and casualty insurer must be recorded as an appropriation of surplus by the ceding company (special surplus from retroactive reinsurance account). Voluntary and general contingency reserves which are not actual liabilities of the reporting entity are shown as appropriated surplus or special surplus funds.
Other Than Special Surplus Funds
15. Amounts provided to reporting entities, other than stock companies, in the organization stage to defray the expenses and meet initial minimum surplus requirements required to obtain a license to do the business of insurance shall be reported as a separate component of surplus called Other than Special Surplus Funds. Examples of these types of deposits include but are not limited to: guaranty fund notes, contribution certificates, and subscriber accounts that represent individual subscriber contributions.

Changes in Statutory Surplus
16. The components of the change in the capital and surplus accounts shall be presented for each year for which an income statement is presented.

Disclosure
17. The financial statements shall disclose the following items:

   a. the number of shares of each class of capital stock authorized, issued and outstanding as of the balance sheet date and the par value or stated value of each class;

   b. the dividend rate, liquidation value and redemption schedule (including prices and dates) of any preferred stock issues;

   c. dividend restrictions, if any, and an indication if the dividends are cumulative;

   d. the portion of the profits that may be paid as ordinary dividends to stockholders;

   e. a description of any restrictions placed on the unassigned funds (surplus) funds including for whom the surplus is being held;

   f. for mutual reciprocals and similarly organized entities, the total amount of advances to surplus not repaid, if any;

   g. the total amount of stock held by the reporting entity, including stock of affiliated entities, for special purposes such as conversion of preferred stock, employee stock options and stock purchase warrants;

   h. a description of the reasons for changes in the balances of any special surplus funds from the prior period;

   i. the cumulative portion of unassigned funds (surplus) represented or reduced by each of the following items:

      i. unrealized gains and losses;
      ii. nonadmitted asset values;
      iii. separate account business;
      iv. asset valuation reserves;
      v. provision for reinsurance;

   j. For reciprocal insurance companies only:

      i. the amount of surplus identified as subscriber savings accounts;
      ii. the source of the funds (either from the reciprocal’s operations or contributed by the individual subscriber) and, the reporting location in surplus;
      iii. the conditions upon which the balances are paid to the subscribers;
DISCUSSION

18. The statutory accounting principles set forth in this issue paper adopt current statutory accounting guidance and are also consistent with the statutory guidance for surplus notes set forth in Issue Paper No. 41.

19. This issue paper is consistent with the requirements of the Annual Statement Instructions that the changes in the capital and surplus accounts be reflected for each year for which an income statement is presented. This is consistent with Accounting Principles Board Opinion No. 12, *Omnibus Opinion - 1967* (APB 12) paragraphs 9 and 10. These paragraphs are adopted with modification to eliminate the option of disclosing changes in the notes to the financial statements rather than in the Statement of Capital and Surplus. This issue paper is consistent with the disclosure requirements of paragraphs 10 and 11 of Accounting Principles Board Opinion No. 10, *Omnibus Opinion -1966* (APB 10). Those provisions of APB 10 are adopted herein. This issue paper also adopts paragraph 28 of Accounting Principles Board Opinion No. 9, *Reporting the Results of Operations* and FASB Emerging Issues Task Force Issue No. 88-9, *Put Warrants*, with a modification to reject guidance related to earnings per share.

20. This issue paper expands current statutory accounting to require disclosure of the reasons for changes in the balance of special surplus funds and the components of unassigned funds (surplus) as of the date of the financial statements. This change was made to enhance comparability of financial statements. To the extent that disclosures required by this issue paper are made within specific notes, schedules, or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit reports) shall include all disclosures required by this issue paper.

21. This issue paper rejects FASB Emerging Issue Task Force Issue No. 85-1, *Classifying Notes Received for Capital Stock* (EITF 85-1), which generally requires notes received as capital contributions to be recorded as a debit to equity rather than as an asset. Paragraphs 6 and 9 of this issue paper require that such notes are recorded as admitted assets if they are satisfied by receipt of cash or readily marketable securities prior to the filing of the statement. To the extent that the notes or other receivables are not satisfied, they shall be nonadmitted. This issue paper also rejects FASB Emerging Issue Task Force Issue No. 85-2, *Classification of Costs Incurred in a Takeover Defense* and FASB Technical Bulletin No. 85-6, *Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt*.

22. This issue paper adopts paragraph 12 of Accounting Principles Board Opinion No. 6, *Status of Accounting Research Bulletins* (APB 6) which provides accounting guidance for treasury stock transactions with modification to eliminate the option of recording treasury stock as an asset. Current statutory guidance is limited on recording transactions involving treasury stock. This issue paper rejects paragraphs 1 through 11 and paragraphs 13 through 24 of APB 6.

23. Current statutory accounting does not address stock purchase warrants. The conclusions reached in this issue paper are consistent with APB Opinion No. 14, *Accounting for Convertible Debt and Debt and Debt Issued with Stock Purchase Warrants* (APB 14) which was adopted in Issue Paper No. 80 - Debt. Disclosures regarding stock purchase warrants required by this issue paper are an expansion of current statutory guidance.
24. This issue paper rejects Accounting Research Bulletin No. 43, Chapter 1, Prior Opinions (ARB 43). The underlying concepts addressed by ARB 43, Chapter 1, are addressed within other relevant GAAP literature to the extent they are applicable.

25. Paragraph 14 of this issue paper addresses appropriated surplus and special surplus funds. This statutory accounting treatment is consistent with paragraph 15 of FASB Statement No. 5, Accounting For Contingencies, (FAS 5) and therefore paragraph 15 of FAS 5 is adopted herein.

26. The changes to current statutory accounting referred to in paragraphs 20 through 23 of this issue paper were made to provide guidance where current statutory is silent and practice may be diverse. Providing statutory guidance to be followed by all reporting entities meets the objective of the Statement of Concepts which states:

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

27. The statutory accounting principles set forth in this issue paper are also consistent with references to surplus found in the AICPA Life Audit and Accounting Guide and the AICPA P&C Audit and Accounting Guide. Although GAAP does not specifically address surplus, statutory surplus is not comparable to stockholders’ equity under GAAP. Stockholders’ equity is meant to be a measure of the net equity in a reporting entity held by the owners, while statutory surplus is meant to provide an indication of the excess of assets readily available to meet policyholder obligations over those obligations.

28. Several components of the surplus section of a reporting entity’s statutory balance sheet are also components of the stockholders’ equity section of the reporting entity’s GAAP balance sheet.

a. Capital stock and treasury stock are treated consistently between statutory surplus and stockholders’ equity;

b. Gross paid-in and contributed surplus for statutory reporting purposes is consistent with the accounting treatment afforded to additional paid in capital in a reporting entity’s stockholders’ equity under GAAP reporting.

29. As discussed in Issue Paper No. 41, GAAP treats surplus notes as liabilities and not as equity whereas Issue Paper No. 41 as well as current statutory guidance account for the notes as surplus.

30. Statutory accounting utilizes unassigned funds (surplus) to account for several additional components of policyholder surplus. These items include net income, unrealized gains and losses on investments and unrealized gains and losses resulting from exchange rate fluctuations, nonadmitted asset values, certain statutory liabilities such as the asset valuation reserve and the provision for reinsurance, the effects of changes in accounting principles and corrections of errors, appropriations of surplus, separate accounts, subscriber savings accounts, stock issuance expenses and dividends to stockholders.
31. GAAP requires some of the items in unassigned funds (surplus) to be reflected in retained earnings while others are reported as a separate and distinct component of stockholders’ equity. Those items that are accounted for as part of retained earnings include:
   a. net income;
   b. effect of changes in accounting principles;
   c. corrections of errors;
   d. dividends to stockholders.

GAAP distinguishes between stock dividends and stock splits for purposes of reclassifications between paid in capital and retained earnings although total stockholders’ equity is not affected. This issue paper adopts paragraphs 1 through 4 and 10 through 16 of Accounting Research Bulletin No. 43, Chapter 7B, Stock Dividends and Stock Split-ups.

32. Those items in unassigned funds (surplus) that are reported as separate and distinct components of stockholders’ equity under GAAP include:
   a. unrealized gain or loss on investments;
   b. unrealized gain or loss resulting from exchange rate fluctuations.

The amount of unrealized gains or losses on investments may differ between GAAP and statutory reporting because of the amounts at which investments are reported in the balance sheet under the different bases of accounting. Unrealized gains and losses relating to exchange rate fluctuations will differ as well because GAAP requires certain types of gains and losses relating to exchange rate fluctuations to be charged or credited to operations in the period of the change.

33. GAAP does not recognize statutory liabilities such as the provision for reinsurance or the asset valuation reserve and therefore those items are not components of stockholders’ equity whereas they are components of unassigned funds (surplus).

34. For GAAP, stock issuance expenses are accounted as a reduction of additional paid in capital whereas for statutory purposes they are accounted for as a reduction of unassigned funds (surplus).

Drafting Notes/Comments
- Issue Paper No. 3 - Accounting Changes, provides guidance on reporting changes in accounting principles and corrections of errors.
- Issue Paper No. 84 - Quasi-reorganizations, permits adjustments to surplus and capital accounts for the effects of a quasi-reorganization in limited situations.
- Issue Paper No. 41 - Surplus Notes, provides the accounting and disclosure requirements for such instruments.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
35. Chapter 23, Capital Stock, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share, and the number of shares to be issued and sold so as to provide at least the minimum paid-up capital.
Minimum Capital

Many states require that, upon the organization or admission of an insurance company, a minimum amount of paid-up capital must be established and maintained for that particular company at all future times. If capital exceeds the minimum required, some states may permit reductions of capital with the commissioner’s consent.

Minimum requirements may be based on the number of lines of business a company writes with a minimum amount for the first line and an additional amount for each line. Other states may require a fixed amount for a certain type of company. The requirements of any jurisdiction are intended, in accordance with sound business practices, to meet the needs of the proposed business.

Par Value Requirements

Traditionally, insurance companies have issued one class of stock, par value common stock, and many states have statutes or rules establishing the minimum par value per share.

In recent years, some states have begun permitting insurers to issue the same classes of stock as noninsurers. This includes issuing of common stock with no par value. The par value of a company’s common stock must be consistent with the statutes and regulations of the domiciliary state.

The statutes and regulations of some jurisdictions permit an insurer to issue preferred stock. They should be reviewed carefully prior to the issuance of any preferential shares.

Original Stock Sale

Most states have detailed regulations with regard to the original sale of a company’s stock. These regulations may include, but are not necessarily limited to, provisions relating to the following:

1. Organization permits and certificate of authority;
2. Registration of securities;
3. Form of subscription agreement and subscription requirements;
4. Promoter stock;
5. Consideration for shares;
6. Payment for shares;
7. Form of certificates representing shares;
8. Deposit and escrow requirements;
9. Fractional shares;
10. Liability of subscribers and shareholders for unpaid shares;
11. Shareholders’ pre-emptive rights;
12. Organization expenses and liability of incorporators.

Prior to any organization activity, any individual or group of individuals desiring to establish an insurance company should consult with the regulatory authority of the state in which it will be domiciled. Establishing an insurance company is a complex procedure and careful attention must be paid to the particular requirements of the state of domicile.
Subsequent Stock Issues

The statutes and regulations of the domiciliary state should be consulted prior to the offering or issuance of any stock.

Treasury Stock

Treasury stock is capital stock of the company that has been issued, fully paid for, and subsequently reacquired by the company. It is held for either reissuance or cancellation in the future.

An insurance company is customarily restricted in the amount of treasury stock it is authorized to hold, and in the reasons for holding such stock. The restrictions of some states permit an insurance company to own treasury stock only when the company's net assets exceed the sum of its paid-up capital and its required surplus, after deducting the surplus attributable to unrealized appreciation in value or revaluation of the company's assets, and any increase arising from the surrender of the company's own shares.

Statutes and regulations of the various jurisdictions may vary. In some states, recently organized insurers may only acquire treasury stock with the permission of the state regulatory authority. Reporting requirements have also been promulgated. Statutes may provide that such acquisition be approved by the stockholders or by the board of directors, and require sufficient surplus to cover the acquisition. Some states permit acquisition of the company's own shares without stockholder or board approval for the following purposes:

1. Redemption or purchase of its redeemable shares at a cost not to exceed the redemption price;
2. Elimination of fractional shares;
3. Collection or compromise of debt to the corporation;
4. Payment to dissenting stockholders entitled to payment for their shares.

The acquisition of treasury stock has no effect on either the number of shares issued or the amount of paid-up capital shown in the capital stock account. However, the use of treasury stock for the cancellation of capital stock does reduce the capital stock account. Treasury stock is reported as a reduction of surplus.


36. Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, of the P&C Accounting Practices and Procedures Manual provides the following guidance:

This chapter discusses paid-in or contributed surplus stock companies and organizational surplus for mutual companies, the amounts required upon incorporation, and the amounts to be maintained at all times.

Besides paid-in capital (common stock), stock insurance companies are required to have a minimum amount of initial paid-in surplus. Mutual companies, which, because of their corporate structure, do not issue capital stock are required to have a minimum amount of initial organizational surplus. Most states require companies to maintain a minimum amount of surplus.

Initial contributed or organizational surplus is obtained to provide both protection to the policyholders and the necessary working capital with which a company can pay the expense of commencing business. The minimum surplus a company must have and at all times maintain is customarily somewhat less than the initial amount required to obtain a certificate of authority.
While paid-in or organizational surplus will not be decreased (except upon a return of original investment), unassigned surplus deficits are subtracted from the amount of original surplus to determine if a company has fallen below the required minimum surplus.

Surplus, for purposes of meeting the minimum requirements, consists of:

- Paid-in or contributed surplus for stock companies;
- Guaranty fund surplus for mutual companies;
- Subordinated surplus debentures, notes, or similar instruments;
- Special or appropriated surplus;
- Unassigned surplus;
- Organizational surplus for mutual companies.

**Minimum Surplus Requirements - Stock Companies**

Most states require a minimum surplus at the time of organization. This amount, which is generally represented by paid-in surplus, may be determined by the nature of the company or by the number of lines a company writes. State statutes may further require a minimum surplus to be maintained permanently.

**Minimum Surplus Requirements - Mutual Companies**

Mutual companies, upon organization, are required to have an organizational surplus which usually conforms to the capital required of a stock company. In addition to this permanent surplus, an expendable surplus may also be required at the time of organization. Some states do not require a permanent surplus for a mutual company if the assessment liability of its members is unlimited. The statutes and regulations of the state of domicile should be consulted with regard to the appropriate requirements.

The funds necessary to meet initial surplus requirements will generally be generated either by applications for insurance or by contribution notes.

**Minimum Surplus Requirements - Reciprocals**

State statutes should be reviewed for surplus requirements of reciprocals, which are usually similar to the requirements for mutual companies.

**Capital or Surplus Impairment**

State statutes vary widely with regard to the impairment of capital or minimum surplus in a stock company or a permanent surplus in a mutual company. In most cases, an order or notice is issued requiring correction of the impairment. Correcting such an impairment may entail issuing new capital stock, surplus or contribution notes, subordinated debentures, or some other means such as a contribution to paid-in surplus. If time limitations are not met, further action will be taken.

Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

37. Chapter 25, Unassigned Funds (Surplus), of the P&C Accounting Practices and Procedures Manual provides the following guidance:
Unassigned funds (surplus) is the undistributed and unappropriated amount of surplus and includes net income as well as the following items.

**Unrealized Capital Gains and Losses on Investments**

The annual statement includes a framework for calculating the unrealized capital gains and losses. Unrealized capital gains and losses result from a change in the prescribed statement value of investments between reporting dates. The change in the net unrealized capital gain or loss is a direct credit or charge to unassigned surplus.

**Change in Nonadmitted Assets**

The change in nonadmitted assets between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 9-Nonadmitted Assets.)

**Change in Liability for Unauthorized Reinsurance**

Where credit is not allowed for unauthorized reinsurance, the ceding insurer must establish a liability. Any change in the liability should be charged or credited directly to unassigned surplus. (See Chapter 22-Reinsurance.)

**Change in Foreign Exchange Adjustment**

Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

**Change in Excess of Statutory Reserves Over Statement Reserves**

Certain liability and compensation loss and loss expense reserves are subject to statutory minimums. The change in such statutory reserve between the current and prior years statement is charged or credited directly to unassigned surplus. (See Chapter 10-Losses.)

**Dividends to Stockholders**

Dividends to stockholders may only be paid from unassigned surplus. The amount available may be affected by numerous factors; for example, the insurance laws of the state of domicile, the existence of contractual commitment such as a borrowing agreement, etc. The corporation, as a matter of policy through its board of directors, may limit the amount of dividends and retain profits.

Dividends declared by the board are charged directly to unassigned surplus and are carried as a liability in the balance sheet until paid. The amount of the dividend is the actual amount paid in cash, the fair market value of the property, or the par value of the company's stock. A stock dividend is recorded as a transfer from unassigned surplus to capital.

**Stock Issuance Expenses**

Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees, are chargeable to the unassigned surplus account and not to paid-in surplus.

**Appropriations of Surplus**

A company may establish a segregated surplus account to provide for contingencies. Surplus thus segregated is called appropriated surplus or special surplus funds. Voluntary and general contingency reserves which are not actual liabilities of the company should be shown as appropriated surplus or as special surplus funds. An appropriation of surplus is recorded as a transfer from unassigned surplus to special surplus funds.
Subscribers Savings Accounts

Subscribers Savings Accounts (SSA) represent a portion of a reciprocal insurance company’s surplus that has been identified as subscribers (policyholders) accounts. SSA is unique to reciprocals as the policyholders are also the owners of the company.

There are two sources for deposits to subscriber accounts. In the first, the individual subscriber may be the source of certain deposits to subscriber accounts, as some reciprocals may require subscriber contributions to join the reciprocal. In the second, the reciprocal is the source, by identifying as SSA a portion of its unassigned surplus generated from its operations. The source of SSA has a bearing on the proper financial statement presentation.

When the source of amounts credited to the subscriber accounts is the individual subscriber, these amounts should be reported in Other Than Special Surplus.

When the source of amounts credited to the subscriber accounts is from the reciprocals operations, it is appropriate to report these amounts as Unassigned Surplus. In this case, the individual subscriber accounts are merely an internal recordkeeping device and not an indicator of restrictions on the funds, or an obligation to pay these amounts to the subscribers. Reciprocal-generated funds that are identified as SSA are an integral part of the company’s operational surplus and are fully available to meet the obligations of the reciprocal. Therefore, when the source of SSA is the reciprocal, financial statement presentation should report SSA as part of the Unassigned Surplus. The Notes to Financial Statements should also disclose pertinent information concerning amounts identified as SSA and conditions of repayment. The amount of surplus from operations that is identified as SSA is generally at the determination of the management of the company and its Board of Directors.

SSA balances may be paid, depending upon domiciliary state law, to subscribers upon termination of their association with the company, regardless of the source of the SSA. In this instance, any unpaid amounts owed to terminated subscribers must be reported as a liability.

Also, if deemed prudent by the company management, periodic partial payments from SSA may be made to subscribers under certain predetermined situations. For example, distributions may be made to those subscribers whose account balances exceed an established threshold. If the company has declared that it will distribute a certain amount of its Unassigned Surplus identified as SSA, but has not actually distributed the amounts by the next reporting date then the company should decrease Unassigned Surplus by the amount approved and report the unpaid amount as a liability. Other than these instances, SSA is typically not owed to the subscribers, and should not be treated as a liability.

Chapter 28, Unassigned Funds (Surplus), of the Life/A&H Accounting Practices and Procedures Manual contains similar guidance.

38. The NAIC Annual Statement Instructions require the following disclosures regarding capital and surplus and policyholders’ dividend restrictions.

Instruction:

a. Shareholders’ dividends - State terms of dividend restrictions, if any; indicate if dividends are cumulative and indicate what proportion of the profits of the company may be paid to stockholders.

b. For each issue of preferred stock, indicate exact description of issue, dividend rate, par value, stated value and liquidation value. If the preferred stock is redeemable, indicate the redemption prices and dates.

c. Unassigned surplus - Describe any restrictions which have been placed on the unassigned surplus funds. Indicate for whom the surplus is being held, and for mutual companies only, the total amount of advances to surplus not repaid, if any.
d. Indicate the total amount of stock held by the company, including stock of affiliated companies, for special purposes such as conversion of preferred stock and employee stock options.

39. Section 4 of the Life and Health Reinsurance Agreements Model Regulation provides the following guidance for ceded reinsurance:

C(1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer’s actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

C(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer’s statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the “Reinsurance ceded” line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million - $6.8 million) which is reported on the “Aggregate write-ins for gains and losses in surplus” line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the “Commissions and expense allowances on reinsurance ceded” line of the Summary of Operations.

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC’s annual statement would report $1.65 million (66% of ($4 million - $1 million - $.5 million) up to a maximum of $13.2 million) on the “Commissions and expense allowance on reinsurance ceded” line of the Summary of Operations, and -$1.65 million on the “Aggregate write-ins for gains and losses in surplus” line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.)

40. The Annual Statement Instructions require the following disclosures for Subscriber Savings Accounts:

Instruction:

For reciprocal insurance companies only, describe the amount of surplus identified as subscriber savings accounts; indicate the source of the funds (either from the reciprocal’s operations or contribution by the individual subscriber) and, the reporting location in surplus; and describe the conditions upon which the balances are paid to the subscribers.

Illustration:

At December 31, 19XX the Company has $_____ identified to subscriber savings accounts. Of this amount, $_____ is from company operations and is reported in Unassigned Funds (Page 3, Line 24C). The balance identified to subscriber savings account, $____, was contributed directly by subscribers and is separately reported in Other Than Special Surplus Funds (Page 3,
Line 23C). The subscriber savings account balances are paid to the subscribers upon the termination from the Company.

**Generally Accepted Accounting Principles**

41. ARB 43, Chapter 1, *Prior Opinions*, provides the following guidance:

1. Unrealized profit should not be credited to income account of the corporation either directly or indirectly, through the medium of charging against such unrealized profits amounts which would ordinarily fall to be charged against income account. Profit is deemed to be realized when a sale in the ordinary course of business is effected, unless the circumstances are such that the collection of the sale price is not reasonably assured. An exception to the general rule may be made in respect of inventories in industries (such as packing-house industry) in which owing to the impossibility of determining costs it is a trade custom to take inventories at net selling prices, which may exceed cost.

2. Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made there against. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.

3. Earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus of the parent company and subsidiaries; nor can any dividend declared out of such surplus properly be credited to the income account of the parent company.

4. While it is perhaps in some circumstances permissible to show stock of a corporation held in its own treasury as an asset, if adequately disclosed, the dividends on stock so held should not be treated as a credit to the income account of the company.

5. Notes or accounts receivable due from officers, employees, or affiliated companies must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

6. If capital stock is issued nominally for the acquisition of property and it appears that at about the same time, and pursuant to a previous agreement or understanding, some portion of the stock so issued is donated to the corporation, it is not permissible to treat the par value of the stock nominally issued for the property as the cost of that property. If stock so donated is subsequently sold, it is not permissible to treat the proceeds as a credit to surplus of the corporation.

**Section B -- Opinion Issued by Predecessor Committee**

1. Following an inquiry made by the New York Stock Exchange, a predecessor committee on accounting procedure in 1938 issued the following report:

“Profits or Losses on Treasury Stock”

2. “The executive committee of the American Institute of Accountants has directed that the following report of the committee on accounting procedure, which it received at a meeting on April 8, 1938, be published, without approval or disapproval of the committee, for the information of members of the Institute:
To the Executive Committee,
American Institute of Accountants:

3. "This committee has had under consideration the question regarding treatment of purchase and sale by a corporation of its own stock, which was raised during 1937 by the New York Stock Exchange with the Institute’s special committee on cooperation with stock exchanges.

4. "As a result of discussions which then took place, the special committee on cooperation with stock exchanges made a report which was approved by the committee on accounting procedure and the executive committee, and a copy of which was furnished to the committee on stock list of the New York Stock Exchange. The question raised was stated in the following form:

5. "Should the difference between the purchase and resale prices of a corporation’s own common stock be reflected in earned surplus (either directly or through inclusion in the income account) or should such difference be reflected in capital surplus?"

6. "The opinion of the special committee on cooperation with stock exchanges reads in part as follows:

7. "Apparently there is general agreement that the difference between the purchase price and the stated value of a corporation’s common stock purchased and retired should be reflected in capital surplus. Your committee believes that while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by such purchase and retirement, such transactions relate to the capital of the corporation and do not give rise to corporate profits or losses. Your committee can see no essential difference between (a) the purchase and retirement of a corporation’s own common stock and the subsequent issue of common shares, and (b) the purchase and resale of its own common stock."

8. "This committee is in agreement with the views thus expressed; it is aware that such transactions have been held to give rise to taxable income, but it does not feel that such decisions constitute any bar to the application of correct accounting procedure as above outlined.

9. "The special committee on cooperation with stock exchanges continued and concluded its report with the following statement:

10. "Accordingly, although your committee recognizes that there may be cases where the transactions involved are so inconsequential as to be immaterial, it does not believe that, as a broad general principle, such transactions should be reflected in earned surplus (either directly or through inclusion in the income account)."

11. "This committee agrees with the special committee on cooperation with stock exchanges, but thinks it desirable to point out that the qualification should not be applied to any transaction which, although in itself inconsiderable in amount, is a part of a series of transactions which in the aggregate are of substantial importance.

12. "This committee recommends that the views expressed be circulated for the information of members of the Institute."

42. APB 12, Omnibus Opinion 1967, provides the following guidance:

9. Paragraph 7 of APB Opinion No. 9, Reporting the Results of Operations, states that “The statement of income and the statement of retained earnings (separately or combined) are designed to reflect, in a broad sense, the results of operations.” Paragraph 28 of APB Opinion No. 9 states that certain capital transactions “. . . should be excluded from the determination of net income or the results of operations under all circumstances.” Companies generally have reported the current year’s changes in stockholders’ equity accounts other than retained earnings in separate statements or notes to the financial statements when presenting both financial position and results of operations for one or more years. A question has arisen as to whether,
because of the language of APB Opinion No. 9, changes in stockholders’ equity accounts other than retained earnings are required to be reported.

10. When both financial position and results of operations are presented, disclosure of changes in the separate accounts comprising stockholders’ equity (in addition to retained earnings) and of the changes in the number of shares of equity securities during at least the most recent annual fiscal period and any subsequent interim period presented is required to make the financial statements sufficiently informative. Disclosure of such changes may take the form of separate statements or may be made in the basic financial statements or notes thereto.

43. Accounting Principles Board Opinion No. 9, *Reporting the Results of Operations*, provides the following guidance:

**Capital Transactions**

28. The Board reaffirms the conclusion of the former committee on accounting procedure that the following should be excluded from the determination of net income or the results of operations under all circumstances: (a) adjustments or charges or credits resulting from transactions in the company’s own capital stock, 5 (b) transfers to and from accounts properly designated as appropriated retained earnings (such as general purpose contingency reserves or provisions for replacement costs of fixed assets) and (c) adjustments made pursuant to a quasi-reorganization.

44. APB 10, Omnibus Opinion - 1966 requires the following disclosures for liquidation preferences:

10. Companies at times issue preferred (or other senior) stock which has a preference in involuntary liquidation considerably in excess of the par or stated value of the shares. The relationship between this preference in liquidation and the par or stated value of the shares may be of major significance to the users of the financial statements of those companies and the Board believes it highly desirable that it be prominently disclosed. Accordingly, the Board recommends that, in these cases, the liquidation preference of the stock be disclosed in the equity section of the balance sheet in the aggregate, either parenthetically or “in short,” rather than on a per share basis or by disclosure in notes.

11. In addition, the financial statements should disclose, either on the face of the balance sheet or in notes pertaining thereto:

   a. the aggregate or per share amounts at which preferred shares may be called or are subject to redemption through sinking fund operations or otherwise;
   b. the aggregate and per share amounts of arrearages in cumulative preferred dividends.

45. FAS 5 provides the following guidance with respect to appropriations of retained earnings:

**Appropriation of Retained Earnings**

15. Some enterprises have classified a portion of retained earnings as “appropriated” for loss contingencies. In some cases, the appropriation has been shown outside the stockholders’ equity section of the balance sheet. Appropriation of retained earnings is not prohibited by this Statement provided that it is shown within the stockholders’ equity section of the balance sheet and is clearly identified as an appropriation of retained earnings. Costs or losses shall not be charged to an appropriation of retained earnings, and no part of the appropriation shall be transferred to income.

46. APB 6, *Status of Accounting Research Bulletins* provides the following guidance for treasury stock transactions:

12. The Board considers that the following accounting practices, in addition to the accounting practices indicated in Chapter 1B, are acceptable, and that they appear to be more in accord with current developments in practice:
a. When a corporation’s stock is retired, or purchased for constructive retirement (with or without an intention to retire the stock formally in accordance with applicable laws):
   
i. an excess of purchase price over par or stated value may be allocated between capital surplus and retained earnings. The portion of the excess allocated to capital surplus should be limited to the sum of (a) all capital surplus arising from previous retirements and net “gains” on sales of treasury stock of the same issue and (b) the prorata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable prorata to shares of common stock. Alternatively, the excess may be charged entirely to retained earnings in recognition of the fact that a corporation can always capitalize or allocate retained earnings for such purposes.
   
ii. an excess of par or stated value over purchase price should be credited to capital surplus.

b. When a corporation’s stock is acquired for purposes other than retirement (formal or constructive), or when ultimate disposition has not yet been decided, the cost of acquired stock may be shown separately as a deduction from the total of capital stock, capital surplus, and retained earnings, or may be accorded the accounting treatment appropriate for retired stock, or in some circumstances may be shown as an asset in accordance with paragraph 4 of Chapter 1A of ARB 43. “Gains” on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; “losses” may be changed to capital surplus to the extent that previous net “gains” from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

c. Treasury stock delivered to effect a “pooling of interests” should be accounted for as though it were newly issued, and the cost thereof should receive the accounting treatment appropriate for retired stock.

13. Laws of some states govern the circumstances under which a corporation may acquire its own stock and prescribe the accounting treatment therefore. Where such requirements are at variance with paragraph 12, the accounting should conform to the applicable law. When state laws relating to acquisition of stock restrict the availability of retained earnings for payment of dividends or have other effects of a significant nature, these facts should be disclosed.

47. EITF 85-1, *Classifying Notes Received for Capital Stock*, provides the following guidance.

**Issue**
An enterprise receives a note, rather than cash, as a contribution to its equity. The transaction may be a sale of capital stock or a contribution to paid-in capital.

The issue is whether an enterprise should report the note receivable as a reduction of shareholders’ equity or as an asset.

**EITF Discussion**
The Task Force reached a consensus that reporting the note as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time. Some Task Force members would require collateralization, or payment of the note prior to issuance of the financial statements, to permit asset recognition.

The SEC requires that public companies report notes received in payment for the enterprise’s stock as a deduction from shareholders’ equity. Task Force members confirmed that the
predominant practice is to offset the notes and stock in the equity section. However, such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements.

Some Task Force members stated that they were aware of very few cases in which nonpublic companies reported such notes as an asset except in circumstances in which they (1) were secured by irrevocable letters of credit or other liquid collateral or were discountable at a bank and (2) included a stated maturity in a reasonably short period of time.

The SEC Observer stated that, for registrants, exceptions to the general rule would be very rare.

Status
No further EITF discussion is planned.

48. ARB 43, Chapter 7B, Stock Dividends and Split-ups, provides the following guidance:

Section B -- Stock Dividends and Stock Split-ups

1. The term stock dividend as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term stock split-up as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

As to the Issuer
Stock dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation’s assets or its respective shareholders’ proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent
otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word dividend in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a split-up effected in the form of a dividend.

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.
RELEVANT LITERATURE

Statutory Accounting
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 23, Capital Stock, Chapter 24, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 25, Unassigned Funds (Surplus)
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 26, Capital Stock, Chapter 27, Paid-In or Contributed Surplus and Organizational Surplus, Chapter 28, Unassigned Funds (Surplus)
- NAIC Annual Statement Instructions
- Life and Health Reinsurance Agreements Model Regulation
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 9 - Subsequent Events
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 73 - Nonmonetary Transactions
- Issue Paper No. 41 - Surplus Notes
- Issue Paper No. 75 - Property and Casualty Reinsurance
- Issue Paper No. 78 - Employee Stock Ownership Plans
- Issue Paper No. 80 - Debt
- Issue Paper No. 81 - Foreign Currency Transactions and Translations
- Issue Paper No. 82 - Stock Option and Stock Purchase Plans
- Issue Paper No. 83 - Accounting for Income Taxes
- Issue Paper No. 84 - Quasi-reorganizations

Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Property & Casualty Insurance Companies
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies
- Accounting Research Bulletin No. 43, Chapter 1, Prior Opinions. Chapter 7B, Stock Dividends and Stock Split-ups
- Accounting Principles Board Opinion No. 6, Status of Accounting Research
- Accounting Principles Board Opinion No. 9, Reporting the Results of Operations Bulletins
- Accounting Principles Board Opinion No. 10, Omnibus Opinion 1966
- Accounting Principles Board Opinion No. 12, Omnibus Opinion 1967
- Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Emerging Issues Task Force Issue No. 85-1, Classifying Notes Received for Capital Stock
- FASB Emerging Issue Task Force Issue No. 85-2, Classification of Costs Incurred in a Takeover Defense
- FASB Emerging Issues Task Force Issue No. 88-9, Put Warrants
- FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending against a Takeover Attempt

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 73

Nonmonetary Transactions

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE


3. The purpose of this issue paper is to establish statutory accounting principles for nonmonetary transactions that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. The definitions of certain terms used in this issue paper are:
   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash; amounts due from agents, brokers, and intermediaries; policy loans; accounts payable and other amounts receivable or payable in cash.
   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are investments in common stocks; furniture fixtures and equipment; real estate and liabilities for rent collected in advance.
   c. Exchange (or exchange transaction) is a reciprocal transfer between a reporting entity and another entity that results in the reporting entity acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.
   d. Nonreciprocal transfer is a transfer of assets or services in one direction, either from a reporting entity to its owners (whether or not in exchange for their ownership interests) or another entity, or from owners or another entity to the reporting entity. A reporting entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.
5. Except as addressed in other issue papers, as discussed in paragraph 11 of this issue paper, nonmonetary transactions shall be accounted for in accordance with APB 29 which is excerpted in paragraph 20 of this issue paper. The accounting for such transactions shall be based on the fair values, as defined in APB 29, paragraph 25, of the assets (or services) involved. In a reciprocal transfer, the fair value of the asset surrendered shall be used to measure the cost unless the fair value of the asset received is more clearly evident. A nonmonetary asset received in a nonreciprocal transfer shall be recorded at the fair value of the asset received. A nonmonetary asset transferred to a stockholder or other entity in a nonreciprocal transfer shall be accounted for at the fair value of the asset transferred and a gain or loss on disposition of the asset recognized for the difference, if any, between fair value and carrying value of the asset transferred.

6. Fair value of assets received or transferred in a nonreciprocal transfer shall be measured based on statutory accounting principles for the type of asset transferred. Accordingly, the value shall be determined in accordance with Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities, Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 32 - Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities), Issue Paper No. 37 - Mortgage Loans, Issue Paper No. 39 - Reverse Mortgages, Issue Paper No. 40 - Real Estate Investments, Issue Paper No. 43 - Loan-backed and Structured Securities or other applicable statement. The guidance provided in Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties shall be followed in accounting for nonreciprocal transactions.

7. Stock received in the form of a stock dividend or stock split shall not result in the recognition of income. The cost basis of stock held shall be reallocated ratably to the total shares held after receipt of the stock dividend or stock split.

8. Involuntary conversions of nonmonetary assets to monetary assets (for example, as a result of total or partial destruction, theft, seizure, or condemnation) are monetary transactions for which gain or loss shall be recognized even though a reporting entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with the conclusions in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) or Issue Paper No. 20 - Gain Contingencies (Issue Paper No. 20), as applicable. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be reported consistently with the reporting entity’s reporting of continuing operations and disclosed in the notes to financial statements in accordance with Issue Paper No. 24 - Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

9. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for in accordance with Issue Paper No. 83 - Accounting for Income Taxes.

Disclosure
10. A reporting entity that engages in a nonmonetary transaction during a period shall disclose in the financial statements or notes thereto the nature of the transaction, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.
DISCUSSION

11. Although not meant to be all inclusive, accounting for specific nonmonetary transactions and unique circumstances is addressed in the following issue papers:

- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (Issue Paper No. 25),
- Issue Paper No. 68 - Business Combinations and Goodwill,
- Issue Paper No. 72 - Statutory Surplus,
- Issue Paper No. 78 - Employee Stock Ownership Plans, and
- Issue Paper No. 82 - Stock Option and Stock Purchase Plans.

12. This issue paper establishes a general rule for accounting for nonmonetary transactions not specifically addressed in the issue papers noted above and expands on current statutory guidance to establish guidance for stock dividends and stock splits received, other types of nonmonetary transactions and involuntary conversions of nonmonetary assets to monetary assets. The guidance established in this issue paper is consistent with the guidance provided in Issue Paper No. 30 which addresses cash dividends and requires that dividends on common stock be recorded as investment income when declared with a corresponding receivable to be extinguished upon receipt of cash. This issue paper also expands the disclosure requirements related to nonmonetary transactions.

13. This issue paper adopts APB 29.

14. This issue paper adopts ARB 43, Chapter 7, Section B paragraphs 1 through 9 as such relates to the receipt of stock in the form of a stock dividend or stock split. This conclusion is consistent with the recognition concept included in the Statement of Concepts which states “Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed”.

15. This issue paper adopts FIN 30 with modification to provide that gain or loss contingencies be recognized in accordance with the conclusions in Issue Paper No. 5 or Issue Paper No. 20, as applicable, and that gain or loss resulting from an involuntary conversion of nonmonetary assets to monetary assets be accounted for in continuing operations and disclosed in accordance with Issue Paper No. 24.

16. This issue paper adopts EITF 86-29 and EITF 93-11 consistent with the general rule discussed in paragraph 12 above.

17. This issue paper rejects paragraph 16 of Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins and Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners

18. The conclusions above are consistent with the recognition concept included in the Statement of Concepts. The recognition concept states:

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

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

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

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

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

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

Generally Accepted Accounting Principles
20. APB 29 provides the following guidance:

INTRODUCTION
1. Most business transactions involve exchanges of cash or other monetary assets or liabilities\(^1\) for goods or services. The amount of monetary assets or liabilities exchanged generally provides an objective basis for measuring the cost of nonmonetary assets or services received by an enterprise as well as for measuring gain or loss on nonmonetary assets transferred from an enterprise. Some transactions, however, involve either (a) an exchange with another entity (reciprocal transfer\(^1\)) that involves principally nonmonetary assets or liabilities\(^1\) or (b) a transfer of nonmonetary assets for which no assets are received or relinquished in exchange (nonreciprocal transfer\(^1\)). Both exchanges and nonreciprocal transfers that involve little or no monetary assets or liabilities are referred to in this section as nonmonetary transactions.

\(^1\) See paragraph 3 of this Opinion for definitions of these terms.

2. Questions have been raised concerning the determination of the amount to assign to a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction and also concerning the recognition of a gain or loss on a nonmonetary asset transferred from an enterprise in a nonmonetary transaction. Practice has varied; some nonmonetary transactions have been accounted for at the estimated fair value of the assets transferred and some at the amounts at which the assets transferred were previously recorded. This opinion sets forth the views of the Board on accounting for nonmonetary transactions.
Definitions

3. The meanings of certain terms used in this section are:

   a. Monetary assets and liabilities are assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Examples are cash, short- or long-term accounts and notes receivable in cash, and short- or long-term accounts and notes payable in cash.2

   b. Nonmonetary assets and liabilities are assets and liabilities other than monetary ones. Examples are inventories; investments in common stocks; property, plant and equipment; and liabilities for rent collected in advance.2

   c. Exchange (or exchange transaction) is a reciprocal transfer between an enterprise and another entity that results in the enterprise's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.3

   d. Nonreciprocal transfer3 is a transfer of assets or services in one direction, either from an enterprise to its owners (whether or not in exchange for their ownership interests) or another entity or from owners or another entity to the enterprise. An entity's reacquisition of its outstanding stock is an example of a nonreciprocal transfer.

   e. Productive assets are assets held for or used in the production of goods or services by the enterprise. Productive assets include an investment in another entity if the investment is accounted for by the equity method but exclude an investment not accounted for by that method. Similar productive assets are productive assets that are of the same general type, that perform the same function or that are employed in the same line of business.

Applicability

4. This Opinion does not apply to the following transactions:

   a. A business combination accounted for by an enterprise according to the provisions of APB Opinion No. 16, Business Combinations,

   b. A transfer of nonmonetary assets solely between companies or persons under common control, such as between a parent company and its subsidiaries or between two subsidiary corporations of the same parent, or between a corporate joint venture and its owners,
c. Acquisition of nonmonetary assets or services on issuance of the capital stock of an enterprise,\(^4\) and

\(^4\) The Board has deferred consideration of accounting for those transactions pending completion and consideration of Accounting Research Studies on intercorporate investments and stockholders' equity except to the extent they are covered in APB Opinion No. 25, Accounting for Stock Issued to Employees.

d. Stock issued or received in stock dividends and stock splits which are accounted for in accordance with ARB No. 43, Chapter 7B.

This Opinion applies to regulated companies in accordance with the Addendum to APB Opinion No. 2, Accounting for the Investment Credit, 1962 and it amends APB Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, to the extent it relates to measuring transfers of certain nonmonetary assets. Some exchanges of nonmonetary assets involve a small monetary consideration, referred to as “boot,” even though the exchange is essentially nonmonetary. This Opinion also applies to those transactions. For purposes of applying this Opinion, events and transactions in which nonmonetary assets are involuntarily converted (for example, as a result of total or partial destruction, theft, seizure, or condemnation) to monetary assets that are then reinvested in other nonmonetary assets—are monetary transactions since the recipient is not obligated to reinvest the monetary consideration in other nonmonetary assets.

DISCUSSION

Present Accounting for Nonmonetary Transactions

5. Nonreciprocal Transfers with Owners. Some nonmonetary transactions are nonreciprocal transfers between an enterprise and its owners. Examples include (a) distribution of nonmonetary assets, such as marketable equity securities, to stockholders as dividends, (b) distribution of nonmonetary assets, such as marketable equity securities, to stockholders to redeem or acquire outstanding capital stock of the enterprise, (c) distribution of nonmonetary assets, such as capital stock of subsidiaries, to stockholders in corporate liquidations or plans of reorganization that involve disposing of all or a significant segment of the business (the plans are variously referred to as spin-offs, split-ups, and split-offs), and (d) distribution of nonmonetary assets to groups of stockholders, pursuant to plans of rescission or other settlements relating to a prior business combination, to redeem or acquire shares of capital stock previously issued in a business combination. Accounting for decreases in owners' equity that result from nonreciprocal nonmonetary transactions with owners has usually been based on the recorded amount of the nonmonetary assets distributed.

6. Nonreciprocal Transfers with Other Than Owners. Other nonmonetary transactions are nonreciprocal transfers between an enterprise and entities other than its owners. Examples are the contribution of nonmonetary assets by an enterprise to a charitable organization and the contribution of land by a governmental unit for construction of productive facilities by an enterprise. Accounting for nonmonetary assets received in a nonreciprocal transfer from an entity other than an owner has usually been based on fair value of the assets received while accounting for nonmonetary assets transferred to another entity has usually been based on the recorded amount of the assets relinquished.

7. Nonmonetary Exchanges. Many nonmonetary transactions are exchanges of nonmonetary assets or services with another entity. Examples include (a) exchange of product held for sale in the ordinary course of business (inventory) for dissimilar property as a means of selling the product to a customer, (b) exchange of product held for sale in the ordinary course of business (inventory) for similar product as an accommodation - that is, at least one party to the exchange reduces transportation costs, meets immediate inventory needs, or otherwise reduces
costs or facilitates ultimate sale of the product—and not as a means of selling the product to a customer, and (c) exchange of productive assets—assets employed in production rather than held for sale in the ordinary course of business—for similar productive assets or for an equivalent interest in similar productive assets. Examples of exchanges in category (c) include the trade of player contracts by professional sports organizations, exchange of leases on mineral properties, exchange of one form of interest in an oil producing property for another form of interest, exchange of real estate for real estate. Accounting for nonmonetary assets acquired in a nonmonetary exchange has sometimes been based on the fair value of the assets relinquished and sometimes on the recorded amount of the assets relinquished.

Differing Views

8. Views of accountants differ as to appropriate accounting for all of the types of nonmonetary transactions described in paragraphs 5 to 7.

9. Nonreciprocal Transfers of Nonmonetary Assets to Owners. Some believe that accounting for nonreciprocal transfers of nonmonetary assets to owners should be based on the carrying amount of the nonmonetary assets transferred because only that method is consistent with the historical cost basis of accounting.

10. Others believe that accounting for transfers of nonmonetary assets to reduce certain owners' interests other than through a reorganization, liquidation, or rescission of a prior business combination should be based on the fair value of the nonmonetary assets distributed or the fair value of the stock representing the owners' equity eliminated, whichever is more clearly evident. In their view, disposing of the value represented by a nonmonetary asset is a significant economic event, and the unrecorded increase or decrease that has resulted in the value of the nonmonetary asset since its acquisition should be recognized.

11. Many who agree with accounting based on fair value for a nonreciprocal transfer of a nonmonetary asset that reduces certain owners' interests also believe that distributing a nonmonetary asset as an ordinary dividend (but not distributing a nonmonetary asset as a liquidating dividend or in a spin-off, reorganization or similar distributions) may be regarded as equivalent to an exchange with owners and therefore recorded at the fair value of the nonmonetary asset distributed, particularly if the dividend is distributable as either cash or the nonmonetary asset at the election of the owner. They believe that failure to recognize the fair value of nonmonetary assets transferred may both misstate the dividend and fail to recognize gains and losses on nonmonetary assets that have already been earned or incurred by the enterprise and should be recognized on distributing the assets for dividend purposes.

12. Others generally agree with the view that nonreciprocal transfers of nonmonetary assets to certain owners should be accounted for at fair value but believe that dividends and other prorata distributions to owners are essentially similar to liquidating dividends or distributions in spin-offs and reorganizations and should be accounted for at the recorded amount of the asset transferred.

13. Nonreciprocal Receipts of Nonmonetary Assets. Many believe that a nonmonetary asset received in a nonreciprocal transfer from other than owners should be recorded at fair value because fair value is the only value relevant to the recipient enterprise. Others believe that such nonmonetary assets should be recorded at a nominal value since fair value cannot be reasonably determined in view of performance obligations usually agreed to by the recipient as a consideration for the transfer.

14. Nonreciprocal Transfers of Nonmonetary Assets to Other Than Owners. Some believe that accounting for a nonreciprocal transfer of a nonmonetary asset to an entity other than an owner should be based on the carrying amount of the asset transferred because only that method is consistent with the historical cost basis of accounting. Others believe that failure to recognize the fair value of a nonmonetary asset transferred may both understate (or overstate) expenses incurred and fail to recognize gains or losses on nonmonetary assets that have already
been earned or incurred by the enterprise and should be recognized when the transfer of the asset is recognized as an expense.

15. Exchange Transactions. Some believe that accounting for an exchange of nonmonetary assets between an enterprise and another entity (an enterprise or individual acting in a capacity other than a stockholder of the enterprise) should be based on the fair values of the assets involved, while others believe that accounting for the exchange should be based on the carrying amount of the asset transferred from the enterprise. Those who advocate the former view believe it to be the only method consistent with the accounting principle that an asset acquired should be recorded at its cost as measured by the fair value of the asset relinquished to acquire it. Those advocating the latter view believe that revenue should be recognized only if an exchange involves monetary assets; therefore recognizing fair value is inappropriate unless a monetary asset is received in an exchange.

16. Many accountants who accept the concept that accounting for an exchange of nonmonetary assets should be based on fair value believe that problems of measurement and questions about the conditions for recognizing revenue require modification of the concept in two types of exchanges. They therefore conclude that:

a. Fair values should not be recognized if an enterprise exchanges product or property held for sale in the ordinary course of business for product or property to be sold in the same line of business. The emphasis in that exchange, in their view, is on developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, “swapping” inventories between enterprises that are essentially competitors and not customers of each other is merely an incidental early stage of an earning process, and revenue should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise.

b. Fair value should not be recognized if an enterprise exchanges a productive asset for a similar productive asset or an equivalent interest in the same or similar productive asset. Therefore, revenue should not be recognized merely because one productive asset is substituted for a similar productive asset but rather should be considered to flow from the production and sale of the goods or services to which the substituted productive asset is committed.

17. Fair Value Not Determinable. General agreement exists that a nonmonetary transaction, regardless of form, should not be recorded at fair value if fair value is not determinable within reasonable limits. Major uncertainties concerning realizability of the fair value proposed to be assigned to a nonmonetary asset received in a nonmonetary transaction are indicative of an inability to determine fair value within reasonable limits. Some believe that only an exchange transaction between parties with essentially opposing interests provides an independent test of fair value to be used in measuring the transaction; therefore fair value is determinable within reasonable limits only in a negotiated exchange transaction. Others believe that fair value in a nonreciprocal transfer is also often determinable within reasonable limits and should be recognized in certain types of transactions.

OPINION

Basic Principle

18. The Board concludes that in general accounting for nonmonetary transactions should be based on the fair values of the assets (or services) involved which is the same basis as that used in monetary transactions. Thus, the cost of a nonmonetary asset acquired in exchange for another nonmonetary asset is the fair value of the asset surrendered to obtain it, and a gain or loss should be recognized on the exchange. The fair value of the asset received should be used to measure the cost if it is more clearly evident than the fair value of the asset surrendered.
Similarly, a nonmonetary asset received in a nonreciprocal transfer should be recorded at the fair value of the asset received. A transfer of a nonmonetary asset to a stockholder or to another entity in a nonreciprocal transfer should be recorded at the fair value of the asset transferred, and a gain or loss should be recognized on the disposition of the asset. The fair value of an entity's own stock reacquired may be a more clearly evident measure of the fair value of the asset distributed in a nonreciprocal transfer if the transaction involves distribution of a nonmonetary asset to eliminate a disproportionate part of owners' interests (that is, to acquire stock for the treasury or for retirement).

5 See paragraph 25 for determination of fair value.

19. The Board believes that certain modifications of the basic principle are required to accommodate problems of measurement and questions about the conditions for recognizing revenue. These modifications are specified in paragraphs 20 to 23.

Modifications of the Basic Principle

20. Fair Value Not Determinable. Accounting for a nonmonetary transaction should not be based on the fair values of the assets transferred unless those fair values are determinable within reasonable limits (paragraph 25).

21. Exchanges. If the exchange is not essentially the culmination of an earning process, accounting for an exchange of a nonmonetary asset between an enterprise and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary asset relinquished. The Board believes that the following two types of nonmonetary exchange transactions do not culminate an earning process:

   a. An exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange, and

   b. An exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset (similar productive asset is defined in paragraph 3 and examples are given in paragraph 7).6

6 The fact that an exchange of productive assets is not a taxable transaction for tax purposes may be evidence that the assets exchanged are similar for purposes of applying this Opinion.

22. The exchanges of nonmonetary assets that would otherwise be based on recorded amounts (paragraph 21) may include an amount of monetary consideration. The Board believes that the recipient of the monetary consideration has realized gain on the exchange to the extent that the amount of the monetary receipt exceeds a proportionate share of the recorded amount of the asset surrendered. The portion of the cost applicable to the realized amount should be based on the ratio of the monetary consideration to the total consideration received (monetary consideration plus the estimated fair value of the nonmonetary asset received) or, if more clearly evident, the fair value of the nonmonetary asset transferred. The Board further believes that the entity paying the monetary consideration should not recognize any gain on a transaction covered in paragraph 21 but should record the asset received at the amount of the monetary consideration paid plus the recorded amount of the nonmonetary asset surrendered. If a loss is indicated by the terms of a transaction described in this paragraph or in paragraph 21, the entire indicated loss on the exchange should be recognized.
23. Nonreciprocal Transfers to Owners. Accounting for the distribution of nonmonetary assets to owners of an enterprise in a spin-off or other form of reorganization or liquidation or in a plan that is in substance the rescission of a prior business combination should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value) of the nonmonetary assets distributed. A prorata distribution to owners of an enterprise of shares of a subsidiary or other investee company that has been or is being consolidated or that has been or is being accounted for under the equity method is to be considered to be equivalent to a spin-off. Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution.

Applying the Basic Principle

24. The Board’s conclusions modify to some extent existing practices as described in paragraphs 5 to 7. The conclusions are based on supporting reasons given in paragraphs 8 to 17.

25. Fair value of a nonmonetary asset transferred to or from an enterprise in a nonmonetary transaction should be determined by referring to estimated realizable values in cash transactions of the same or similar assets, quoted market prices, independent appraisals, estimated fair values of assets or services received in exchange, and other available evidence. If one of the parties in a nonmonetary transaction could have elected to receive cash instead of the nonmonetary asset, the amount of cash that could have been received may be evidence of the fair value of the nonmonetary assets exchanged.

26. Fair value should be regarded as not determinable within reasonable limits if major uncertainties exist about the realizability of the value that would be assigned to an asset received in a nonmonetary transaction accounted for at fair value. An exchange involving parties with essentially opposing interests is not considered a prerequisite to determining a fair value of a nonmonetary asset transferred; nor does an exchange insure that a fair value for accounting purposes can be ascertained within reasonable limits. If neither the fair value of a nonmonetary asset transferred nor the fair value of a nonmonetary asset received in exchange is determinable within reasonable limits, the recorded amount of the nonmonetary asset transferred from the enterprise may be the only available measure of the transaction.

27. A difference between the amount of gain or loss recognized for tax purposes and that recognized for accounting purposes may constitute a temporary difference to be accounted for according to FASB Statement No. 109, Accounting for Income Taxes.

Disclosure

28. An enterprise that engages in one or more nonmonetary transactions during a period should disclose in financial statements for the period the nature of the transactions, the basis of accounting for the assets transferred, and gains or losses recognized on transfers.7

7 Paragraph 12 of ARB No 51, Consolidated Financial Statements, includes additional disclosures that are preferred if a parent company disposes of a subsidiary during the year.

21. ARB 43, Chapter 7, Section B provides the following guidance (only the pertinent excerpts are included below):

As to the Recipient
5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the separate entity concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known. The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in Eisner v. Macomber, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

   "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased ... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

22. FIN 30 provides the following guidance (only the pertinent excerpts are included below):

1. The FASB has been asked whether gain or loss results from an involuntary conversion of a nonmonetary asset to monetary assets if the monetary assets are subsequently reinvested in a similar nonmonetary asset. Generally, if a nonmonetary asset is involuntarily converted, gain or loss for the difference between the cost of the nonmonetary asset and the amount of monetary assets received has been recognized in income in the period of the involuntary conversion. In other cases, that difference has been accounted for as an adjustment to the cost basis of a nonmonetary asset that is subsequently acquired as replacement property.

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1 The terms “nonmonetary” and “monetary” as used in this Interpretation have the same meaning as those terms have in APB Opinion No. 29, Accounting for Nonmonetary Transactions.
INTERPRETATION

2. Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. As discussed in paragraph 11 of this Interpretation, however, the requirement to recognize gain does not apply to certain involuntary conversions of LIFO inventories.\(^3\)

3 Paragraph 14(b) of APB Opinion No. 28, Interim Financial Reporting, provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.

3. In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies.

4. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets shall be classified in accordance with the provisions of APB Opinion No. 30, Reporting the Results of Operations---Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.

5. Gain or loss resulting from an involuntary conversion of a nonmonetary asset to monetary assets that is not recognized for income tax reporting purposes in the same period in which the gain or loss is recognized for financial reporting purposes is a temporary difference for which comprehensive recognition of deferred taxes, as described in FASB Statement No. 109, Accounting for Income Taxes, is required.

23. EITF 86-29 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

The basic principle contained in Opinion 29 is that the exchange of nonmonetary assets should be recorded at fair value. Certain modifications to that basic principle are contained in paragraphs 21 and 22 of Opinion 29. (The Task Force previously discussed certain aspects of those modifications in Issues No. 84-29, “Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot,” and No. 85-43, “Sale of Subsidiary for Equity Interest in Buyer.”)

The issues are (1) how the accounting for certain nonmonetary transactions should be affected by the magnitude of boot and (2) how the exceptions to the use of fair value should be applied.

EITF DISCUSSION

The Task Force reached a consensus that the decision as to whether an exchange involving products or properties held for sale (paragraph 21(a) of Opinion 29) should be measured using the recorded amounts or fair value depends on whether the products or properties received will be sold in the same line of business as the products or properties given up.

Further, the Task Force reached a consensus that the decision as to whether an exchange of similar productive assets (paragraph 21(b)) should be measured using the recorded amounts or fair value should be based on a "same line of business" test.
Some Task Force members expressed the view that the exchange of a controlled business (as defined in ARB 51) for an investment in an entity that is not controlled, but is in the same line of business, would not necessarily meet the definition of a similar productive asset and would have to be evaluated based on individual facts and circumstances. No consensus was reached on this issue.

The Task Force reached a consensus that a product or property held for sale and exchanged for a productive asset did not fall within the modifications to the basic principle of Opinion 29 (even if they were in the same line of business) and should be recorded at fair value.

The Task Force discussed an exchange of nonmonetary assets that would otherwise be based on recorded amounts but that also involves boot, reached a consensus that the transaction should be considered monetary (rather than nonmonetary) if the boot is significant, and agreed that "significant" should be defined as at least 25 percent of the fair value of the exchange. As a monetary transaction, both parties would record the exchange at fair value. If the boot in a transaction is less than 25 percent, the pro rata gain recognition guidance in paragraph 22 of Opinion 29 should be applied by the receiver of boot, and the payer of boot would not recognize a gain. The Task Force acknowledged that the ability to satisfactorily measure fair value is a prerequisite to the use of fair value.

The Task Force also discussed various exchanges involving investments accounted for by consolidation and by the equity method. The Task Force reached a consensus that an enterprise should account for an exchange of securities in which it acquires control of a subsidiary as a business combination in accordance with Opinion 16. An enterprise should account for an exchange of securities accounted for by consolidation or by the equity method for an investment in which it does not acquire control of a business but for which it will account by the equity method, as a nonmonetary transaction in accordance with Opinion 29. The Task Force noted that the provisions of this consensus were not intended to apply to exchanges involving joint ventures or the acquisition of a minority interest.

Additionally, several Task Force members and the SEC Observer expressed concern that a literal application of the consensus to an exchange in which an enterprise acquires control of a business could result in the recognition of gain on transactions that are in substance an exchange of similar productive assets or result in a 100 percent write-up of an asset in circumstances in which an entity has not transferred control of the asset. For example, Company A transfers an asset to Company B in exchange for shares of Company B. As a result of the exchange, Company A acquires control of Company B; Company A also indirectly retains control of the asset received by Company B. The Task Force agreed that Company A should account for this transaction as a partial sale (to minority shareholders of Company B), and gain recognition should be limited to that portion of the asset treated as sold. If Company B accounts for the exchange at fair value, profit applicable to the portion of the asset indirectly controlled by Company A would be eliminated in Company A's consolidation of Company B.

Further, the Task Force observed that the consensus is not intended to change the application of Opinion 16 or to eliminate the need to exercise judgment in those circumstances in which the substance of a transaction indicates that fair value accounting is not appropriate. That is, if Opinion 16 is to apply, the substance of the transaction must be a business combination.

STATUS

Issues relating to the exchange of real estate involving boot were discussed in Issue No. 87-29, "Exchange of Real Estate Involving Boot." For that Issue, the Task Force reached a consensus that a transaction involving an exchange of similar real estate that is considered a monetary transaction under Issue 86-29 because boot is at least 25 percent of the fair value of the exchange would be allocated between two components: a monetary portion and a nonmonetary portion. (An exchange of similar real estate is defined in Issue 87-29 as an exchange of either (a) real estate held for sale in the ordinary course of business for real estate to be sold in the same line of business or (b) real estate not held for sale in the ordinary course of business for similar
The allocation between the monetary and nonmonetary portions of the transaction should be based on their relative fair values at the time of the transaction. For the receiver of boot, the monetary portion would be accounted for under Statement 66 as the equivalent of a sale of an interest in the underlying real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. For the payer of boot, the monetary portion would be accounted for as an acquisition of real estate, and the nonmonetary portion would be accounted for under paragraph 21 of Opinion 29. Exhibit 87-29A presents an example of the application of the consensus reached on Issue 87-29.

No further EITF discussion is planned.

24. EITF 93-11 provides the following guidance (only the pertinent excerpts are included below):

ISSUE

In a barter transaction involving barter credits, an enterprise enters into a transaction to exchange a nonmonetary asset (for example, inventory) for barter credits. Those transactions may occur directly between principals to the transaction or include a third party whose business is to facilitate those types of exchanges (for example, a barter company).

The barter credits can be used to purchase goods or services, such as advertising time, from either the barter company or members of its barter exchange network. The goods and services to be purchased may be specified in a barter contract or limited to items made available by members of the exchange network. Some arrangements may require the payment of cash in addition to the barter credits to purchase goods or services. Barter credits also may have a contractual expiration date, at which time they become worthless.

The issue is whether Opinion 29 should be applied to an exchange of a nonmonetary asset for barter credits and, if so, the amount of profit or loss, if any, that should be recognized.

EITF DISCUSSION

The Task Force reached a consensus that transactions in which nonmonetary assets are exchanged for barter credits should be accounted for under Opinion 29. An impairment of the nonmonetary asset exchanged should be recognized prior to recording the exchange if the fair value of that asset is less than its carrying amount. The impairment should be measured as the amount by which the carrying amount of the asset exceeds its fair value. Recognition of an impairment loss also would be required in an exchange of assets or contractual rights not reported in the balance sheet (for example, operating leases) if the transferor is not relieved of primary liability for the related obligation. The definition of fair value in paragraph 13 of Statement 15 may be useful in determining the fair value of the nonmonetary asset. The Task Force noted that fair value should not be based on an estimate of the value of the barter credits to be received. After an impairment is recognized, the reduced carrying amount of the nonmonetary asset becomes its new cost. [Note: See STATUS section.]

If an exchange involves the transfer or assumption of an operating lease, impairment of that lease should be measured as the amount of the remaining lease costs (discounted rental payments and unamortized leasehold improvements) in excess of the discounted amount of probable sublease rentals for the remaining lease term. [Note: See STATUS section.]

The Task Force also reached a consensus that in reporting the exchange of a nonmonetary asset for barter credits, it should be presumed that the fair value of the nonmonetary asset exchanged is more clearly evident than the fair value of the barter credits received and that the barter credits should be reported at the fair value of the nonmonetary asset exchanged. The Task Force noted, however, that that presumption might be overcome if an entity can convert the barter credits into cash in the near term, as evidenced by a historical practice of converting barter credits into cash shortly after receipt, or if independent quoted market prices exist for items to be received upon exchange of the barter credits. It also should be presumed that the fair value of the
nonmonetary asset does not exceed its carrying amount unless there is persuasive evidence supporting a higher value. An impairment loss on the barter credits should be recognized if it subsequently becomes apparent that (1) the fair value of any remaining barter credits is less than the carrying amount or (2) it is probable that the enterprise will not use all of the remaining barter credits.

STATUS

In March 1995, the FASB issued Statement 121 which requires that long-lived assets and certain identifiable intangibles to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Statement 121 establishes accounting standards for the recognition and measurement of impairment losses and sets forth an approach to determining an asset's fair value. Statement 121 also requires that long-lived assets and certain identifiable intangibles to be disposed of be reported at the lower of carrying amount or fair value less cost to sell.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Introduction, Accounting for Assets Transferred Between Affiliates
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 20 - Gain Contingencies
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 30 - Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated companies)
- Issue Paper No. 68 - Business Combinations and Goodwill
- Issue Paper No. 72 - Statutory Surplus
- Issue Paper No. 78 - Employee Stock Ownership Plans
- Issue Paper No. 82 - Stock Option and Stock Purchase Plans
- Issue Paper No. 83 - Accounting for Income Taxes

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 6, Status of Accounting Research Bulletins, paragraph 16
- Accounting Principles Board Opinion No. 29, Accounting for Nonmonetary Transactions
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section B, Stock Dividends and Stock Split-ups
- FASB Interpretation No. 30, Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets
- FASB Emerging Issues Task Force Issue No. 86-29, Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value
- FASB Emerging Issues Task Force Issue No. 93-11, Accounting for Barter Transactions Involving Barter Credits
- Emerging Issues Task Force No. 96-4, Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 74

Life, Deposit-Type and Accident and Health Reinsurance

STATUS
Finalized March 16, 1998

Type of Issue:
Life Specific

SUMMARY OF ISSUE

1. Reinsurance is an agreement by which a reporting entity transfers all or part of its risk under a contract to another reporting entity. Current statutory guidance on the accounting for life and accident and health reinsurance is contained in Chapters 17, 21 and 24 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for life and accident and health reinsurance is primarily contained in FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113). In several instances, FAS 113 differs from the current statutory guidance.

3. The purpose of this issue paper is to establish statutory accounting principles for reinsurance of life, deposit-type and accident and health contracts that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to life and accident and health contracts and deposit-type contracts as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force (Issue Paper No. 50). The provisions of Chapter 24 of the Life/A&H Accounting Practices and Procedures Manual (Chapter 24) and the accounting related items in the proposed Actuarial Guideline JJJ - Guideline Concerning Questions and Answers Related to the Life and Health Reinsurance Agreements Model Regulation (the proposed Actuarial Guideline JJJ), which provided further clarification of reinsurance accounting as provided in Chapter 24, are adopted as the statutory accounting principles for life and accident and health reinsurance except that all deposit-type contracts reinsured are to be accounted for under the Deposit Accounting section of Chapter 24. Goodwill resulting from the deferral of losses by the assuming entity at the inception of assumption reinsurance agreements shall be included in the total goodwill of a reporting entity when calculating the amount of goodwill that is a nonadmitted asset pursuant to Issue Paper No. 68 - Business Combinations and Goodwill.

5. With respect to other accounting matters, the provisions of Chapter 17 (included in paragraph 14 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to reinsurance in unauthorized companies and funds held under reinsurance treaties with unauthorized reinsurers are adopted as statutory accounting principles. The provisions of Chapter 21 (included in paragraph 15 of this issue paper) of the Life/A&H Accounting Practices and Procedures Manual that relate to commissions and expense allowances on ceded and assumed reinsurance are adopted as statutory accounting principles. In addition, the Annual Statement Instructions require reinsurance disclosures in notes 10 through 15 to the Annual Statement. These disclosures (included in paragraph 18 of this issue paper) are also adopted as statutory accounting principles.
6. If it is probable that reinsurance recoverables on paid or unpaid claim or benefit payments will be uncollectible, consistent with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets, amounts shall be written off through a charge to the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.

DISCUSSION

7. The statutory accounting for life and accident and health reinsurance was recently revised through amendments to Chapter 24 and further clarified by the proposed Actuarial Guideline JJJ. The GAAP guidance for life and accident and health reinsurance is contained principally within FAS No. 113 which is adopted with modification for property and casualty reinsurance in Issue Paper No. 75 - Property and Casualty Reinsurance and by this issue paper for life, deposit-type and accident and health reinsurance. This issue paper applies to all accident and health reinsurance written by life and health and property and casualty insurers. The statutory accounting principles established by this issue paper differ substantially from GAAP, reflecting much more detailed guidance as follows:

a. Reserve credits taken by ceding entities as a result of reinsurance contracts are netted against the ceding entity’s policy and claim reserves and unpaid claims. Under GAAP, reinsurance recoverables are reported as assets.

b. For statutory reporting, first year and renewal ceding commissions on indemnity reinsurance of new business (ceding commissions on ceded in-force business are included in the calculation of initial gain or loss, see paragraph 7.d.) are recognized as income. Under GAAP, ceding commissions are reported first as a reduction of deferred acquisition costs (DAC) and then if DAC is completely eliminated any excess is established as unearned revenue.

c. As discussed in Issue Paper No. 50, statutory accounting defines deposit-type contracts as those contracts which do not include any mortality or morbidity risk. GAAP defines investment contracts as those that do not subject the reporting entity to significant policyholder mortality or morbidity risk. (The distinction is any mortality or morbidity risk for statutory purposes vs. significant mortality or morbidity risk for GAAP purposes.) Therefore, a contract may be considered an investment contract for GAAP purposes, and that same contract may be considered other than deposit-type for statutory purposes. A reinsurance treaty covering contracts that have insignificant mortality or morbidity risk (i.e., contracts classified as other than deposit-type contracts for statutory purposes, but investment contracts for GAAP purposes) that does not transfer that mortality or morbidity risk, but does transfer all of the significant risk inherent in the business being reinsured (e.g., lapse, credit quality, reinvestment or disintermediation risk) qualifies for reinsurance accounting for statutory reporting purposes, but would not qualify for reinsurance accounting treatment for GAAP purposes.

d. For statutory reporting, initial gains or losses on indemnity reinsurance of in-force blocks of business have unique accounting treatment. A portion of the initial gains or losses (equal to the tax effect of the initial gain or loss in surplus) is reported as commissions and expense allowances on reinsurance ceded in the statement of operations. The remainder of the initial gains or losses is reported on a net-of-tax basis as a write-in for gain or loss in surplus in the Capital and Surplus Account. In subsequent years, the ceding entity recognizes income on the reinsurance ceded line for the net-of-tax profits that emerged on the reinsured block of business with a corresponding decrease in the write-in for gain or loss in surplus. Under GAAP, the cost of reinsurance is amortized to income over the life of the reinsured contracts or the reinsurance contract period, depending on whether the reinsurance contract is long or short-duration. The difference,
if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

e. Statutory accounting prohibits recognition of a gain or loss in connection with the sale, transfer or reinsurance of an in-force block of business between affiliated entities in a non-economic transaction. Any difference between the assets transferred by the ceding entity and the liabilities, including unamortized IMR, shall be deferred and amortized under the interest method. Under GAAP, such transactions are treated as capital contributions or dividends.

f. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

g. Statutory accounting as defined in Chapter 24 prescribes offsetting certain reinsurance premiums. However, FAS 113 states that for GAAP, offsets can occur only when a right of setoff exists.

8. Amounts due from reinsurers on paid claims and benefits are reported as assets under both statutory accounting and GAAP. Reserve credits deducted by ceding entities from their direct and assumed policy and claim reserves and unpaid claims represent amounts that will be recovered from reinsurers. These reinsurance recoverables meet the statutory definition of an asset established in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets; however, this asset will continue to be presented as a contra liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the NAIC Annual Statement.

9. This issue paper maintains current statutory accounting principles that require that losses to the assuming entity at the inception of assumption reinsurance agreements (i.e., liabilities exceed assets) be deferred as goodwill and amortized over the life of the policies, but for a period not to exceed 10 years. This issue paper clarifies that goodwill recorded by an assuming entity related to an assumption reinsurance agreement shall be considered with goodwill of an entity in determining the amount of goodwill to be nonadmitted. If assets exceed liabilities at the inception of the assumption reinsurance agreement, the assuming entity shall record a deferred liability and amortize the amount using the interest method over the expected life of the business, but for a period not to exceed 10 years.

10. Issue Paper No. 52 - Deposit-Type Contracts (Issue Paper No. 52) establishes statutory accounting principles for income recognition and policy reserves for deposit-type contracts. Under Issue Paper No. 52, reinsurance of deposit-type contracts, which by definition do not have insurance risk, will be accounted for under the provisions of the Deposit Accounting section of Chapter 24. This is consistent with the GAAP treatment of investment contracts under FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, but is inconsistent with reinsurance accounting treatment in Chapter 24 which would allow for reinsurance accounting treatment if the risks other than mortality and morbidity were transferred.

11. The impact of gains or losses from reinsurance of in-force blocks of business can be effectively monitored because such gains and losses are shown as a single line item in the surplus section.

12. The statutory accounting for non-economic assumption reinsurance transactions between affiliated entities is consistent with Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.
13. The statutory requirement to establish a liability, Reinsurance in Unauthorized Companies, for unsecured reinsurance recoverables from unauthorized reinsurers is contained in various state statutes, the Life/A&H Accounting Practices and Procedures Manual (Chapter 17) and the Instructions to the Life, Accident and Health Annual Statement, Schedule S - Part 3. This requirement maintains current statutory accounting, and is consistent with the recognition concept and conservatism concept in the Statement of Concepts, which also allows for certain mandated liabilities.

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

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

**Drafting Notes/Comments**

- Deposit accounting for Property and Casualty Companies is currently being considered by the AICPA. Codification may have to be amended to acknowledge an additional SAP/GAAP difference should the AICPA adopt guidance for Life Insurance Companies that differs from Chapter 24.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

14. Chapter 17 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on reinsurance in unauthorized companies:

**Reinsurance in Unauthorized Companies**

This liability is established to offset credit taken in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers. Credit for reinsurance with unauthorized companies also may be permitted if the ceding company holds securities or cash of the assuming company equal to the reserve credit taken. Such deposits are to be held under the control of the ceding company. Additionally, any securities held under such an arrangement must be investments that the ceding company is allowed to make under the provision of the investment sections of the insurance statutes. Other permissible arrangements include irrevocable trusts or “clean” letters of credit. If the assuming company is not licensed or is not an authorized reinsurer in the domiciliary state of the ceding company or if the reinsurance does not meet required standards, the ceding company must set up a net liability equal to the following:

1. Reserve credits taken including any Interest Maintenance Reserve (IMR) liability adjustment, plus
2. Claim liability credits taken on paid and unpaid (in course of settlement) claims recoverable, plus
3. Other asset increases or liability reductions resulting from amounts recoverable from the assuming company including commissions, expense allowances, modified coinsurance reserve adjustments, experience rating refunds, and estimated incurred but not reported claim liabilities, less
4. Deposits by or funds withheld from the reinsurer, as provided for in the reinsurance treaty, pledged as security for the payment of reinsurance obligations. Such deposits or
funds are typically held by the ceding company or are placed in a trust or custodial agreement. Amounts placed in trust or custodial accounts are held subject to withdrawal by, and under the control of, the ceding insurer, less

5. Amounts of reinsurance recoverables covered by a clean, irrevocable letter of credit issued by a qualified banking institution, less

6. Amounts contractually due the assuming company.

The net liability defined above should never be less than zero for any particular reinsurer. Caution should be exercised in taking credit for items in 4, 5, and 6 above since state requirements vary considerably. The change in liability for unauthorized reinsurance is a direct charge or credit to surplus.

**Funds Held Under Reinsurance Treaties with Unauthorized Reinsurers**

This liability is for funds deposited by or contractually withheld from unauthorized reinsurers. Please note that the withholding of reinsurance premiums represents only one method of securing net reinsurance liabilities. Letters of credit from or funds escrowed in a financial institution represent two other commonly accepted methods.

15. Chapter 21 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance on expense allowances and reinsurance commissions:

**Expense Allowances on Reinsurance**

For reinsurance it is common for the assuming insurer to provide an expense allowance to cover expenses of the ceding insurer. The allowance is frequently nonspecific with respect to premium taxes and other general expenses of the ceding insurer and it is usually combined with and accounted for as part of the commissions on reinsurance assumed or ceded.

The portion of reinsurance expense allowances which represents specific reimbursement of premium taxes should be accounted for as premium tax. Any portion specifically reimbursing general expenses should be accounted for as other general expense. Each should be excluded from commissions and expense allowances on reinsurance assumed or ceded.

**Reinsurance Commission Accounting Practices**

Under current statutory accounting practices and procedures, commissions on direct business, commissions and expense allowances on reinsurance assumed, and commissions and expense allowances on reinsurance ceded are each accounted for separately in the Summary of Operations and on the balance sheet. Accordingly, commissions and expense allowances on reinsurance ceded are reported as income or revenue earned in the Summary of Operations and the balance sheet provision for due and accrued amounts is reported as an asset. This differs from the more customary statutory accounting practice of reporting insurance transactions net of reinsurance in the Summary of Operations and on the balance sheet with reliance upon supporting exhibits for the reinsurance information.


**A. Indemnity Reinsurance**

**Transfer of Risk**

Reinsurance agreements must transfer risk from the ceding company to the reinsurer in order to receive the reinsurance accounting treatment discussed in this chapter. If the terms of the
agreement violate the risk transfer criteria contained herein, i.e., limits or diminishes the transfer of risk by the ceding company to the reinsurer, the agreement shall be accounted for as discussed in the Deposit Accounting section below. In addition, any contractual feature that delays timely reimbursement, violates the conditions of reinsurance accounting.

This paragraph applies to all life and accident and health reinsurance agreements except for yearly renewable term reinsurance agreements and non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance. All reinsurance agreements covering insurance products or similar products of the type identified in A(6) of Appendix A shall follow the guidance for reinsurance accounting contained in this chapter provided the reinsurance agreement (1) transfers significant insurance risk and (2) does not contain any of the conditions set forth in Appendix A. All products not of the type identified in A(6) of Appendix A or covered in the following two paragraphs, shall follow the guidance for reinsurance accounting contained in this chapter provided that the agreement (1) transfers one or more of the risk categories described in A(6) and (2) does not contain any of the conditions set forth in Appendix A. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

Yearly renewable term reinsurance agreements that transfer a proportionate share of mortality or morbidity risk inherent in the business being reinsured and do not contain any of the conditions described in Appendix A(2), (3), (4), (8), (9), (10) or (11), shall follow the guidance for reinsurance accounting. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

For non-proportional reinsurance agreements such as stop loss and catastrophe reinsurance agreements, contract terms should be evaluated to assess whether they transfer significant risk to the reinsurer. For example, prepayment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company limits the risk to the reinsurer. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurer's payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Reinsurance accounting shall apply to all non-proportional agreements that transfer significant risk and do not contain any provisions that protect the reinsurer from incurring a loss. Contracts that fail to meet the requirements for reinsurance accounting shall follow the guidance contained in the Deposit Accounting section.

**Accounting and Reporting of Reinsurance**

The obligation of reporting reinsurance in force and of determining unpaid premiums and incurred claims and other balances is generally on the ceding company because it knows the current status of the policies it has written directly and reinsured. A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding company and the transmittal of information and its entry on the books of the assuming company. The assuming company shall estimate any material unreported premiums and related costs, since it alone has the responsibility for determining its own financial condition and for preparing accurate financial statements.

The ceding company must report these items in its balance sheet:

1. Credits (deductions) to its policy and claim reserves and unpaid claims;
2. Premiums or other amounts payable on reinsured risks;
3. Amounts recoverable on claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses;
4. Modified coinsurance reserves; and
5. Amounts receivable or payable for funds withheld.
Similarly, in its balance sheet, the assuming company must report:

1. Reserves for reinsurance assumed reduced by any modified coinsurance reserves;
2. Reinsurance premiums receivable or other amounts receivable;
3. Amounts payable for claims, surrender values, dividends, experience rating refunds, taxes, commissions, and other expenses; and
4. Amounts receivable or payable for funds withheld by the ceding company.

While the various balances that a company (ceding or assuming) has with its reinsurance partners will result in a net amount, the proper way to report them is in their separate classifications. The balances of one company shall not be netted against those of any other company. Each reinsurance agreement must be accounted for separately.

### Reinsurance Premiums

For all reinsurance arrangements, the assuming company must report premiums under the terms of the reinsurance contract as income and establish any asset or liability consistent with the methods and assumptions used to establish its policy reserves and guidance contained in Chapter 18, Premium Income, of this manual. The ceding company shall reduce premium income by the amounts paid or payable to the reinsurers. The ceding company shall reduce its deferred and uncollected premiums reported as an asset and the assuming company shall record an asset for premiums payable to the reinsurer on those insurance policies with premiums collected on a basis more frequent than annual covered by the reinsurance arrangement. On those insurance policies covered by the reinsurance arrangement with premiums collected annually, the ceding company shall establish a liability and the assuming company shall record an asset for premiums payable to the reinsurer.

### Reinsurance Benefit Payments

Policy benefit payments paid or payable by the reinsurer shall be reported in the Summary of Operations and reduces the ceding company’s reported benefit payments. The reinsurer shall establish a liability for its share of any unpaid claim payments and the ceding company shall reduce any policy and contract claim liability with respect to the reinsured policies or establish a receivable for the amount due from the reinsurer for claims paid.

### Expenses

The taxes, commissions, and other expenses that will be paid by the assuming company to the ceding company are agreed upon when the reinsurance agreement is negotiated. These items are calculated in accordance with the reinsurance agreement and usually relate to premiums or claims or both. At the statement date, the amount of unpaid expenses is generally based upon the amount of premiums and claims unpaid at that date.

Some coinsurance contracts provide that the assuming company pay to the ceding company a commission that exceeds the first-year premium. In the absence of any guarantees for payment of future premiums (for example, persistency guarantees), these commissions are accounted for on the cash basis. If, however, the ceding company guarantees that premiums will be paid in the future, which, in essence, returns the excess commission, it must record the excess commission as a liability. This liability is then to be released as future premiums are paid to the assuming company. The rate of release is determined in accordance with the anticipated experience and reasonable commission rate for first-year and renewal premiums. Excess commissions such as these are nothing more than a means of financing for the ceding company.

If renewal expense allowances in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, a liability is to be established by the ceding company for the present value of the shortfall. In establishing this liability, assumptions are to be used equal to the applicable statutory reserve...
basis on the business reinsured. Anticipated allocable expenses includes commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured.

Experience Refunds

Some reinsurance contracts, generally proportional reinsurance, provide that the reinsurer will refund an agreed upon portion of its profit to the ceding company. The reinsurance contract will provide the calculation and the factors to be included.

If the contract provides for experience refunds, the ceding company must record, as an asset, the amount of the refund receivable as of the statement date, but reduced by any amount that is contingent upon future experience. The assuming company is also required to record, as a liability, the amount of the refund calculated at the statement date, but without regard to any effects that future experience might have.

Credits for Ceded Reinsurance

The credit taken by the ceding company under the coinsurance arrangement is calculated using the same methodology and assumptions used in determining its policy and claim reserves. It is, of course, only for the percentage of the risk that was reinsured. Under modified coinsurance, the reserve credit is reduced by the modco deposit retained by the ceding company. If the company reinsures on a yearly renewable term basis, it is itself buying insurance for the portion of the ceded amount at risk. The amount of yearly renewable term reinsurance that is required on a given policy generally decreases each year as the company’s reserve increases. The net amount at risk may increase, however, on interest sensitive products such as universal life. The amount at risk on accident and health yearly renewal term reinsurance will remain level and the reinsurance premium increases each year.

The reserve credit taken by the ceding company is reported as a reduction to the reserves and not as an asset of the company. The ceding company’s reserve credit and assuming company’s reserve for yearly renewable term reinsurance shall be computed as the one year term mean reserve on the amount of insurance ceded. The ceding company must use the same mortality and interest bases which were used for valuing the original policy before reinsurance. The credit may also be computed on a pro rata basis if the result is not materially different from the credit computed on the mean reserve basis. For all types of reinsurance, the ceding company also takes credit for other amounts due from the reinsurer such as unpaid claims and claims incurred but not reported. If contemplated by the reinsurance contract, recognition of related assets and liabilities must occur (policy loans, due and deferred premiums, etc.).

Non-proportional reinsurance is generally purchased in order to safeguard the company’s aggregate loss potential. This form of reinsurance is entered into on an annual basis to limit the claims experience of the company and thereby protect its financial integrity. When the period of the arrangement exceeds one year, the contract must be carefully reviewed to determine if the end result more closely follows proportional reinsurance. No reserve credit is taken for non-proportional reinsurance unless the aggregate attachment point has in fact been penetrated. In order for a company to reflect reserve credits on a prospective basis, the company will need to demonstrate that the present value of expected recoveries using realistic assumptions and not statutory assumptions required for the underlying policy reserves, to be realized from the reinsurer is in excess of the present value of the reinsurance premiums guaranteed to be paid by the ceding insurer under the terms of the contract. Because non-proportional reinsurance aggregates experience, and does not indemnify the ceding insurer for each policy loss, the use of statutory assumptions underlying the insured policies is inappropriate for determining any reserve credit to be taken by the ceding insurer. Historical experience, pricing assumptions and asset shares should be considered in determining if the reinsurer may be reasonably expected to pay any claims. The reserve credit taken may only reflect these reasonable expectations. This treatment of non-proportional reinsurance is similar to the way property and casualty (P&C) reinsurance is considered. This is because these modes of reinsurance more closely follow P&C
indemnification principles than life insurance formula basis, and because these coverages are very similar to excess insurance on P&C products. In determining the appropriate reserve credit, the probability of a loss penetrating to the reinsurer’s level of coverage (using reasonable assumptions) must be multiplied by the expected amount of recovery. This is the same as reserve credits on coinsurance where the probability of a claim (i.e., mortality) is multiplied by the expected return (i.e., death benefit). In that the coverage is for aggregate experience, the mortality assumptions underlying any one policy risk is inappropriate to analyze the appropriate credits for non-proportional coverage.

Accounting for Interest Maintenance Reserve (IMR)

The interest-related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR in accordance with the IMR instructions contained in the NAIC Annual Statement Instructions Manual.

Reserves for Reinsurance Assumed

In assuming any insurance risks, the assuming company is required to establish policy reserves that are consistent with its obligations. The reserves it must establish, therefore, are also dependent upon the arrangement of reinsurance that is used. For risks transferred under the reinsurance arrangement, policy and claim reserves must be at least equal to the required reserves calculated using the same methodology and assumptions that would be used if the reinsurer had written the risk directly.

Accounting for Modified Coinsurance Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a modified coinsurance arrangement, the following accounting applies.

Ceding Company

In a modified coinsurance arrangement, the ceding company retains the assets equal to the modified coinsurance reserve. This reserve represents a prepayment of the reinsurer’s future obligation. Premiums paid or payable to the reinsurer net of any experience refunds shall result in the reduction of premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company’s reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. The modified coinsurance reserve is included in the category of policy reserves. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer shall increase premium income net of any experience refunds and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The statutory policy reserves excludes the modified coinsurance reserve. The modified coinsurance reserve adjustment from period-to-period shall be reported separately in the Summary of Operations. The reinsurer’s accounting of its obligations shall be consistent with the ceding company’s accounting for the transfer of the obligations.

Accounting for Coinsurance With Funds Withheld Arrangements

When the intent of the parties and the terms of the reinsurance contract are to enter into a coinsurance arrangement with funds withheld, the following accounting applies.
Ceding Company

Premiums paid or payable to the reinsurer net of any experience refunds shall reduce premium income. Policy benefit payments paid by the reinsurer shall reduce the ceding company’s reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations as earned. A net reduction to policy reserves shall be taken for the portion of the obligation assumed by the reinsurer. Any amounts withheld by the ceding company shall be recorded as a separate liability. Any interest due or payable on the amounts withheld shall be recorded as interest on indebtedness.

Assuming Company (Reinsurer)

Premiums received or receivable by the reinsurer net of any experience refunds shall increase premium income and policy benefit payments paid by the reinsurer shall increase the reported policy benefits. Expense allowances paid by the reinsurer shall be reported separately in the Summary of Operations when payable. The reinsurer shall record its share of the statutory policy reserves attributable to the business identified in the contract. Any funds withheld by the ceding company shall be recorded as an accounts receivable. Any interest earned or receivable on the funds withheld shall be recorded as miscellaneous income.

Uncollectible Reinsurance

The ceding and assuming companies must determine if reinsurance receivables are collectible. To the extent that the amounts are determined to be uncollectible, these amounts shall be charged to operations. Companies must write off uncollectible reinsurance receivables through the accounts previously utilized to establish the receivables.

Unauthorized Reinsurance

If the reinsurer is not authorized to do business, or is not otherwise approved, the reinsurance is considered to be unauthorized. The Model Law on Credit for Reinsurance specifying the conditions under which reinsurance credit may be taken, shall be followed. (For further discussion of the liability for unauthorized reinsurance see Chapter 17).

Gains and Losses on Indemnity Reinsurance

Under an indemnity reinsurance arrangement the ceding company continues to be liable to the policyholders and the reinsurer has no obligations to them except in the case of cut-through agreements. Typically the ceding company will continue to perform all functions in connection with claims and other policyholder services. Gains and losses on indemnity reinsurance are defined as the net experience under the reinsurance contract within a calendar year. Net experience (underwriting gains or loss) includes ceded premiums, claims, expense allowances, reserve adjustments, any IMR liability adjustment and experience refunds and dividends.

Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. For reinsurance of in-force blocks of business, gains that occur in the initial calendar year are accounted for in accordance with Section 4, subsection C of Appendix B.

For indemnity reinsurance agreements entered into for other than in-force blocks of business, the gains and losses are immediately recognized by the ceding and assuming company.

Recaptures and Commutations

A recapture or a commutation of a reinsurance agreement is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement or a portion of the agreement. Reasons for commuting reinsurance agreements often include: perceived financial instability of the reinsurer, inefficiencies associated with the runoff of longer tailed liabilities, or significantly different evaluation of ultimate loss costs. The assumed reserves and reserve credits taken are eliminated
by the reinsurer and ceding insurer, respectively. The reinsurer and ceding insurer must also make any required IMR liability adjustment changes. Any net gain or loss is reported in the Summary of Operations.

Deposit Accounting

To the extent that a reinsurance contract does not, despite its form, provide for sufficient transfer of risk, amounts paid are to be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company's books and as a liability on the assuming company's books. The deposit may be reported as an asset in the ceding company's statement if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company's state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. Income and losses shall be recognized by a party when, according to the terms of the contract, it has earned the amount and the other party has no recourse to repayment of such amount in future periods. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other miscellaneous insurance income or miscellaneous insurance loss.

2. No deduction shall be made from the policy or claim reserves on the ceding company's balance sheet, schedules and exhibits.

3. The assuming company shall record net considerations to be returned to the ceding company as liabilities.

B. Assumption Reinsurance

A company may sell all or part of a block of insurance business through an assumption reinsurance agreement. Typically, under an assumption reinsurance arrangement, the reinsurance contract is intended to effect a novation, thereby to extinguish the ceding company's liability to the policyholder. Assumption reinsurance requires that the reinsurer issue assumption certificates to the existing policyholders and take over responsibility for policyholder services. On occasion, the reinsurer will contract with the original company to continue to provide such services on a fee basis or may contract with a third party. Regulatory approval of assumption reinsurance arrangements is usually required. Approval is also usually required from the policyholders, who have a predetermined time period in which to accept or reject the reinsurance transfer. After the deadline has passed, approval is considered implied for all outstanding responses. For those policyholders that reject the transfer, the reinsurance agreement typically converts to a indemnity arrangement. Under this circumstance, reinsurance accounting, as defined earlier in this chapter, is to be followed.

Accounting for Assumption Reinsurance Transactions

Accounting for assumption reinsurance transactions involves all existing assets and liabilities with respect to the assumed policies. This involves policy reserves, policy loans, net due and deferred premiums, dividend accumulations, dividend liability, policy claims, advance premiums, unearned interest on policy loans, etc. The total effect of all of these assets and liabilities is collectively referred to as net policy liabilities.
Typically, because a block of in-force business has value, the sale transaction will result in a gain to the ceding company. If the policies are somewhat mature and have reasonably large net policy liabilities, the transaction probably will result in a transfer of cash or other assets by the ceding company. In this case, the net policy liabilities released by the ceding company will be greater than the value of the assets transferred. If the policies are young and have very small net policy liabilities, the assuming company may pay some amount in the purchase. The ceding company is to follow accounting for indemnity reinsurance for the policies sold until it has been formally relieved of the legal liability by either consent from the policyholders or when the expiration period for objecting to the transfer has expired. Upon release of the liability or risk, the ceding company shall recognize any gain or loss immediately. The gain or loss shall be the difference between the book value of the assets and liabilities including any unamortized IMR allocated or related to the block of business transferred. Direct and ceded balances are to be eliminated and gains are to be taken into income proportionally as the policyholders approve the transfer or at the end of the response period.

The assuming company is to value the assets acquired at the date of acquisition at their market values, and the reserves are to be established according to statutory requirements based on the benefits in the individual policies reinsured. If the liabilities exceed the assets, the difference represents goodwill that must be amortized using the interest method over the life of the policies, but for a period not to exceed 10 years. If the assets exceed the liabilities, the assuming company shall record a deferred liability and amortize the amount using the interest method over the expected life of the business but not to exceed ten years.

Upon initiation of the assumption reinsurance contract, the ceding and assuming companies are to report all balances reinsured as direct adjustments to the Balance Sheet. Any net gain or loss is reported as miscellaneous income when recognized.

**Accounting for Non-economic Assumption Reinsurance Transactions**

When the sale, transfer, or reinsurance of an in-force block of business occurs between affiliated companies that is not an economic transaction, the ceding and assuming company shall not recognize any gain or loss. The statutory liabilities and any unamortized IMR shall be transferred from the ceding company to the assuming company without adjustment. The assuming company shall amortize any transferred IMR at the same rate or amount that would have occurred for the ceding company. To the extent that the value of the assets transferred by the ceding company or the net asset value recorded by the assuming company differs from the liabilities including any unamortized IMR, the ceding and assuming company shall defer and amortize their respective differences consistent with the interest method described for non-affiliated transactions.

**Effective Date**

The revised accounting and reporting practices set forth in this chapter that were adopted on December 4, 1995, shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance agreements entered into or amended on or after January 1, 1996. The revised accounting and reporting practices shall not apply to reinsurance agreements in force on January 1, 1996.

For accounting periods commencing on or after January 1, 1996, agreements which were: (a) entered into on or after January 1, 1996, and which do not transfer risk shall be accounted for as deposits; (b) amended on or after January 1, 1996, and which do not transfer risk shall be accounted for prospectively as deposits with the appropriate reclassification of outstanding reinsurance balances as deposits with no surplus impact; or (c) amended on or after January 1, 1996, a change in accounting principle associated with the revised accounting in this chapter shall be applied prospectively with no adjustment to surplus. Not withstanding the effective dates noted above, any insurer which has previously been subject to compliance with the Life and Health Reinsurance Agreements Model Regulation or substantially similar regulation shall be guided by the effective date of the regulation.
CHAPTER 24 — APPENDIX A

The contents of this appendix is taken from the Life and Health Reinsurance Agreements Model Regulation.

Section 4. Accounting Requirements

A. No insurer subject to this regulation shall, for reinsurance ceded, reduce liability or establish any asset in any financial statement filed with the Department if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

1. Renewal expense allowances provided or to be provided to the ceding ins by the reinsurer in any accounting period are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

2. The ceding insurer can be deprived of surplus or assets at the reinsurer’s option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;

3. The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years’ losses under the agreement nor payment by the ceding insurer of an amount equal to current and prior years’ losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;

4. The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

5. The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer which are greater than the direct premiums collected by the ceding company;

6. The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a
representative sampling of products or type of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

(a) Morbidity

(b) Mortality

(c) Lapse

This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

(d) Credit Quality (Cl)

This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

(e) Reinvestment (C3)

This is the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

(f) Disintermediation (C3)

This is the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations, the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals.

+ – Significant 0 – Insignificant
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<th>c</th>
<th>d</th>
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*LTC = Long Term Care Insurance  
LTD = Long Term Disability Insurance

(7) (a) The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

(b) Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business which do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

- Health Insurance—LTC/LTD
- Traditional Non-Par Permanent
• Traditional Par Permanent
• Adjustable Premium Permanent
• Indeterminate Premium Permanent
• Universal Life Fixed Premium
  (no dump-in premiums allowed)

The associated formula for determining the reserve interest rate adjustment must use a formula which reflects the ceding company’s investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

\[
\text{Rate} = \frac{2(I + CG)}{X+Y-I-CG}
\]

Where:
- \(I\) is the net investment income (Exhibit 2, Line 16, Column 7)
- \(CG\) is capital gains less capital losses (Exhibit 4, Line 10, Column 6)
- \(X\) is the current year cash and invested assets (Page 2, Line 10A, Column 1) plus investment income due and accrued (Page 2, Line 16, Column 1) less borrowed money (Page 3, Line 22, Column 1)
- \(Y\) is the same as \(X\) but for the prior year

Drafting Note: Line references are for the 1992 annual statement. Line references may be deleted or should be updated if regulation is adopted after calendar year 1992. Be aware that annual statement line references may change from year to year.

(8) Settlements are made less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date.

(9) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured.

(10) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured.

(11) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business reinsured and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

CHAPTER 24 — APPENDIX B

B. Notwithstanding Subsection A, an insurer subject to this regulation may, with the prior approval of the commissioner, take such reserve credit or establish such asset as the commissioner may deem consistent with the Insurance Law (or Code), Rules or Regulations, including actuarial interpretations or standards adopted by the Department.

C. (1) Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer’s actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this department. The actuary should maintain adequate
documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

(2) Any increase in surplus net of federal income tax resulting from arrangements described in Subsection C(1) shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account, page 4 of the Annual Statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the “Reinsurance ceded” line, page 4 of the Annual Statement as earnings emerge from the business reinsured.

{For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million—$6.8 million) which is reported on the “Aggregate write-ins for gains and losses in surplus” line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the “Commissions and expense allowances on reinsurance ceded” line of the Summary of Operations.

At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC’s annual statement would report $1.65 million (66% of [$4 million—$1 million—$.5 million] up to a maximum of $13.2 million) on the “Commissions and expense allowance on reinsurance ceded” line of the Summary of Operations, and—$1.65 million on the “Aggregate write-ins for gains and losses in surplus” line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.}

17. The proposed Actuarial Guideline JJJ, which follows, provided further clarification of reinsurance accounting:

Draft: 11/17/95

Adopted by the Life and Health Actuarial (Technical) Task Force on 12/1/95

ACTUARIAL GUIDELINE JJJ

GUIDELINE CONCERNING QUESTIONS AND ANSWERS RELATED TO THE LIFE AND HEALTH REINSURANCE AGREEMENTS MODEL REGULATION

Background

In September 1992 a revision of the Life and Health Reinsurance Agreements Model Regulation was adopted by the NAIC. Since then a number of questions have arisen by regulators regarding its application and interpretation. In early 1994 the Reinsurance Working Group was formed and charged by the Life and Health Actuarial (Technical) Task Force to provide guidance in interpreting provisions of the model regulation. This charge is being met through the completion of this Guideline in the form of a Q&A document which discusses and adds a degree of insight into certain aspects of the regulation. This document is not intended to expand the content of the model regulation. Each state will retain the authority and ability to independently interpret its own regulation. This document gives some insight into the intent of the original drafters of the model regulation and provides interpretive guidance regarding certain of its provisions.
Section 3

Question: Aside from assumption reinsurance, what other type of reinsurance is exempt from the model regulation?

Answer: The model exempts all yearly renewable term (YRT) and certain nonproportional reinsurance arrangements, such as stop loss and catastrophic reinsurance. The purpose behind the exemption of these types of arrangements was because these did not normally provide significant surplus relief and therefore were not the target of this regulation. Users of the regulation should, however, be cautious of any reinsurance arrangements which could be created to misstate a company’s true financial position or attempt to circumvent the regulation by artificially labeling an agreement YRT. If a YRT provides incidental reserve credits for the ceding insurer’s net amount at risk for the year with no other “allowance” to enhance surplus, or a catastrophic arrangement which takes a reserve credit for actual losses beyond the attachment point or the unearned premium reserve (UPR) of the current year’s premium, there will most likely be no regulatory concern. The NAIC Examiners Handbook (Part 5–Reinsurance section) provides significant insight into all reinsurance agreements, whether covered by this regulation or not. Section II(B)(4) provides discussion on a reinsurance agreement’s effect on surplus and provides areas of concern to the regulator in determining a bona fide transfer of risk. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance.

Section 4A

Question: What is disallowed in the case of non-complying coinsurance with funds withheld treaties? modified coinsurance treaties?

Answer: The underlying intent of the section is to ensure that a company’s financial condition is appropriately stated and not distorted by artificially enhancing surplus through “reinsurance” arrangements that do not fully transfer risks to the reinsurer or which otherwise fail to comply with the standards contained in the regulation. Therefore, all reserve credits, liability reductions or assets established by the ceding insurer that are supported by or conditioned on the treaty should be non-admitted to the extent called for in the regulation for any reinsurance agreement that does not comply with Section 4A.

If a reinsurance agreement is such that one or more of its terms violates or fails to comply with the provisions of the model regulation, a company should not include any liability reduction or any asset recognition in any financial statement. A liability reduction or asset may appear in the financial statement in various forms: reserve credits, receivables or transferred funds.

Funds that have been received or credited by the ceding insurer, such as commissions or other front end allowances, regardless of the name given it, shall not be recognized as a surplus enhancement on the annual statement. If so reported, the entire value of such funds currently reported should be non-admitted.

Both forms of coinsurance, funds withheld and modified coinsurance, have an implicit or explicit reserve credit being taken. A modified coinsurance (modco) deposit is also reflected within the same line as an offset to the reserve credit. This ultimately reflects aggregate reserves being reported as if there were no reinsurance. So long as the modco deposit is for the sole purpose of paying FUTURE claims, the modco deposit may be offset against the implicit reserve credit with no additional penalty (other than the nonadmission of any front end allowance as discussed above) being assessed against the ceding insurer.

With regard to coinsurance with funds withheld, the reserve credit taken will be initially nonadmitted. The funds withheld may serve several purposes. It may be funds withheld which the ceding company owes to the reinsurer as a liability payable, such as the last accounting quarter’s
premium payable. The funds may also be used, similar to modco, to hold funds to be applied against FUTURE claim payments, with the funds having no other liability. To the extent that funds are available solely for paying future claims, such amount may be used to reduce the otherwise nonadmitted reserve credit. Care must be taken that no reduction in the nonadmitted reserve credit be taken when funds serve another purpose, such as being payable to the reinsurer, in addition to the reinsurer’s obligation to pay claims.

An insurer is legally able to enter into contracts with other entities, including other insurers. The provisions of such a contract will be required to be accounted for based on the terms and conditions of the agreement. If the agreement meets the conditions of an acceptable reinsurance arrangement, the ceding insurer is afforded the additional benefit of being able to reduce its otherwise required statutory liabilities by a reserve “credit.” If the agreement does not meet the conditions of this regulation, no reserve credit, whether as an asset or as an offset to liability, may be taken. This treatment does not rescind or otherwise eliminate the existence of the contract. Additional pertinent information is contained in the reinsurance chapter of the NAIC Accounting Practices and Procedures Manual which provides accounting guidance for such agreements.

Section 4A(1)

Question: What should be included in the renewal expense allowances with regard to direct expenses? An allocation of salaries? Computer usage? Or just marginal expenses directly related to the business reinsured such as claim payment expenses, postage, etc.? Should the renewal expense allowances cover actual anticipated allocable expenses of a small company in a start-up mode (i.e. high expenses) or should they be based on what expected expenses would be once the company is more mature?

Answer: The primary purpose of the model regulation is to prohibit credit for reinsurance under financial arrangements where the ceding company enters into an agreement for the principal purpose of producing significant surplus aid for the ceding insurer on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured.

Section 4A(1) implements the purpose of the model by prohibiting credit for reinsurance in certain instances where the ceding insurer is afforded a large ceding commission at the inception of the agreement resulting in a significant increase in surplus only to have the surplus increase be drained away in subsequent periods because renewal expense allowances provided under the agreement are insufficient to cover the direct allocable costs estimated at the time the business is reinsured, which are anticipated to be incurred by the ceding insurer in maintaining the business reinsured.

The model allows an exception to complete disallowance of credit for reinsurance in situations where the ceding insurer reflects a liability for the present value of the shortage between renewal expense allowances provided under the agreement and the direct allocable costs expected in the future by the insurer in maintaining the business reinsured. This liability must be calculated using actuarial assumptions that are consistent with those utilized in the statutory reserve calculation. The expenses to be accounted for in establishing this liability should represent all costs of the ceding insurer in servicing the business that is subject to the agreement.

In determining what the ceding insurer should include in the renewal expenses with regard to direct expenses, there should be an allocation of all renewal expenses anticipated at the time the business is reinsured including salaries, computer usage, postage, etc. This comprehensive calculation should be done regardless of whether a company is in a start-up mode (and experiencing high expenses) or is otherwise more mature but, recognizing that the anticipated expense levels may be estimated, a comparison with pricing assumptions may be considered in determining the reasonableness of such assumptions.

If insurance department staff encounter an agreement that does not comply with Section 4A(1) of the model, this area of non-compliance should be addressed by the posting of a reserve for the present value of the deficiency rather than denial for credit for reinsurance, assuming that no
other area of non-compliance is encountered with the agreement and that the assets received corresponding to the ceding commission are in compliance with other statutes and regulations. For example, the assets received corresponding to the ceding commission must be admissible and not subject to repayment to the reinsurer.

NOTE: Some states have adopted versions of the model regulation that do not allow partial credit when renewal expense allowances are deficient. In those states complete disallowance of reinsurance credit would result for treaties that do not comply with the renewal expense allowance requirement.

Section 4A(2)

Question: With regard to existing business, should the coinsurance reserve percentage or the coinsurance reserve amount not be allowed to increase in a combination coinsurance/modified coinsurance treaty? How would the rule be applicable to the difference between the total reserve and the amount of funds withheld in a coinsurance with funds withheld treaty?

Answer: Section 4A(2) disallows reinsurance credit if the ceding company can be deprived of assets at the reinsurer’s option or automatically upon the occurrence of some event. Thus a provision in a coinsurance with funds withheld treaty that allows the reinsurer to convert the treaty to coinsurance at some later date would be in violation of the model regulation. Although the parties could have entered into a coinsurance agreement at its inception, regulators are concerned that the reinsurer would take assets from the ceding company at a time that would be to the detriment of the ceding company’s policyholders.

Under a combination coinsurance/modified coinsurance (co/modco) arrangement the ceding company and the reinsurer both establish reserves for future claim payments. When a claim becomes payable, the reserves held by each party must be used proportionally to pay the claim. Treaty provisions that adjust the reserves each party holds in lieu of transferring funds owed to the reinsurer are acceptable. However, adjustment of reserves in lieu of payment when funds are owed to the ceding company is a violation of the model regulation since it is a depletion of the ceding company’s assets. This is the case even if the agreement provides for this adjustment at inception and never requires a payment to be owed by the reinsurer. Noncompliance with the model regulation would exist if both the coinsurance amount and the coinsurance percentage (for existing business) were allowed to increase on any settlement date.

Under a coinsurance with funds withheld treaty the reinsurer establishes the entire amount of reserve liability on its share of reinsured policies, but the ceding company withholds assets from the reinsurer, typically in an amount less than the reserves, to offset future obligations. There is no duty on the part of the reinsurer to maintain the book value of the withheld assets at a certain level as there is under co/modco, where the book value of the assets supporting the modco reserves must equal the modco reserves. Provided the withheld assets are not withheld for any purpose other than the payment of future claims, it is not a violation of the model regulation for the reinsurer to require full use of withheld assets for the payment of claims prior to using any other assets owned by the reinsurer.

Section 4A(2) and 4A(5)

Question: Should a reinsurer have a unilateral right to establish underlying cost of insurance rates or credited interest rates for policies that are wholly or partially reinsured?

Answer: No, only the ceding company has the contractual relationship with the insured and the right to set the cost of insurance rates charged policyholders and to set the rates of interest credited to them. However, a representation (but not a warranty) that the ceding company shall vary nonguaranteed elements reinsured in a manner consistent with the ceding company’s documented procedures at the time the agreement was entered into does not violate the requirements of the regulation.
Question: May a reinsurance contract allow the reinsurer to increase the cost of insurance that the ceding company must pay under the treaty?

Answer: So long as the aggregate amounts payable by the ceding company in any settlement period do not exceed the income of the reinsured policies during that period, the treaty's structure would not be in violation of Section A(5) of the model regulation. There is not compliance with Section A(5) if any increases could exceed income.

Question: If a reinsured policy allows the ceding company to guarantee rates of interest to be credited to the policyholder that are greater than those guaranteed by the policy, may a reinsurance contract allow the reinsurer to limit its participation in the credited rate as long as it at least provides for the amount based on the rate guaranteed in the contract?

Answer: Again, so long as there is no possibility that the ceding company will have to make payments for which it is not fully reimbursed, no violation exists. Otherwise, the treaty would not be in compliance with Sections 4A(2) and 4A(5).

Section 4A(7)

Question: Is asset segmentation an acceptable mechanism for legal segregation of assets?

Answer: Generally no. Segmentation involves the allocation of a company's general account investment earnings over several lines of business, or various groups of policies within those lines, such that the performance of one corporate bond, for example, may affect the earnings of several segments within a company. The accounting for the segmentation is largely internal, and the detail of the record-keeping varies from company to company.

The fundamental purpose of the requirement for a reinsurance treaty to employ the use of a segregated asset portfolio (SAP) is that all payments (interest, benefits, allowances, etc.) must be made from the SAP, to eliminate any problems that could arise in determining what asset or assets should be sold, and to avoid disputes in the event of insolvency. Any sale of assets that could affect policies not subject to reinsurance, or policies subject to reinsurance with other reinsurers is problematic.

In addition, auditing the performance of a treaty using traditional segmentation methods would be extremely difficult and prone to disagreement, which could provide a reinsurer with broad leverage to contest amounts due that reinsurer, especially in the event of insolvency or rehabilitation of the ceding company.

It is important to determine that the arrangement in place does in fact transfer all of the risks of the underlying assets supporting the reinsured business to the reinsurer.

Question: If some policies out of a group of similar policies are fully or partially reinsured, and the remainder are not, must the assets supporting the reinsured policies be legally segregated from those supporting the business that is not?

Answer: Yes. Assets supporting policies that are not reinsured may not be part of an SAP.

Question: If a percentage of all policies in a block of business is reinsured, must the company segregate that percentage of the assets supporting the business, or can it segregate all the assets?

Answer: The company may segregate only assets supporting the reinsured portion or the segregated asset portfolio may represent the entire block of business if the reinsured portion is the same for all policies. In the later case, the reinsurer would take its proportionate share of the SAP performance.

Question: If the ceding company cedes a portion of each policy in a block of business to one reinsurer and a portion to another, while retaining some itself, does it have to segregate assets
separately for each reinsurer, or is it acceptable to have all the assets segregated together with each reinsurer responsible for its portion of the investment risk?

Answer: The ceding company should not segregate assets separately for each reinsurer if the treaties are virtually identical.

Question: At the time assets are legally segregated under a coinsurance with funds withheld treaty, should they be valued at market value, statutory value or some combination?

Answer: The assets should be valued at their statutory admitted assets value.

Question: When the assets are legally segregated, how are the funds withheld payables and receivables reported?

Answer: The payables and receivables are recorded in the same manner as in a funds withheld treaty where the assets are not legally segregated and will usually mirror the value of the funds withheld account. However, the funds withheld account, which reflects the statutory admitted value of the assets in the SAP, will fluctuate, and thus may differ from the reserves on the reinsured business.

Section 4A(8)

Question: Can a company get around this provision if its treaty states that amounts receivable from the reinsurer are payable (due) at a later date?

Answer: No. All amounts receivable from reinsurers are nonadmitted if not paid within 90 days after the end of the period in which the amounts became receivable. The period may not be longer than one quarter (3 months). These amounts include ceding commissions withheld by reinsurers. A ceding commission is an amount that should be paid “up front” and not over time. Furthermore, arguments that the ceding commission was in fact paid but was then deposited with the reinsurer to create a funds withheld from ceding insurer account are unacceptable. Paid means paid.

Question: Does this section permit modco with funds withheld, since this type of reinsurance involves a receivable from the reinsurer?

Answer: Since the funds withheld would be structured as a receivable, the treaty would be in violation of this section.

Section 4A(9)

Question: Can a treaty impose specific controls on the way the ceding company conducts its business? Examples of such controls include the following:

a. Limits on the amount of dividends to be paid to stockholders in any year.
b. Limits on the amount of new business to be issued in any year.
c. Under certain conditions, the right of the reinsurer to replace the ceding company’s investment manager.
d. Restrictions on the types of investments to be held by the ceding company.
e. Increased risk charges under certain circumstances, such as risk based capital ratios falling to a specified level.

Answer: Treaty provisions such as those illustrated above appear frequently. They represent an understanding between the ceding company and the reinsurer at inception of the treaty. The impact and intent of the provisions must be analyzed to determine that they do not relate to general business practices of the ceding company, and are reasonably related to the business being reinsured; provisions that only apply to the business reinsured would generally not be in violation of Section 4A(9).
Section 4A(10)

Question: When, if ever, may references to projections be made in a reinsurance treaty?

Answer: Accounting Requirement A-10 prohibits treaty provisions where “the ceding insurer is required to make representations or warranties about the future performance of the business being reinsured.” (It should be noted that “representations or warranties” need not appear in a treaty section entitled “Representations and Warranties” to be considered as such.)

Provisions relating to projections appear in the following forms:

a. Tables of scheduled amounts, typically showing the amount of outstanding surplus relief expected at different times during the life of the treaty, clearly drawn from projections of future profitability of the block of business being reinsured, but not identified as such. This does not represent violations of either Accounting Requirement A-9 or of Accounting Requirement A-10, because they were agreed to at inception of the treaty, and are reasonably related to the business being reinsured. However, the treaty must clearly disclose that these tables do not constitute a guarantee as to the future profitability of the business reinsured.

b. Statements acknowledging that, at inception of the treaty, the reinsurer has received and reviewed projections of the future profitability of the business being reinsured. Such statements do not represent a violation of Accounting Requirement A-9 as long as:

1. there is no language in the treaty implying reliance by the reinsurer on such projections, and
2. language is included stating, in essence, that the reinsurer acknowledges that the ceding insurer is unable to make any guarantees regarding the future profitability of the business being reinsured.

c. Statements requiring that, if “projected results are not met,” the reinsurer will take some form of action, such as an increased risk charge. The statements differ from those discussed in Paragraph a. above in that numerical values (drawn from the projections) are not shown in the treaty. Language of this type would be in violation of Accounting Requirement A-10 because it implies a warranty about the future performance of the business being reinsured, on the basis of projections that are not part of the contract.

18. The Annual Statement Instructions require the following disclosures related to reinsurance. Notes 10-12 relate to all reserves including direct, assumed and ceded business. Notes 13-15 relate specifically to reinsurance.

10. Life and Annuities Reserves

Instruction:

A. Describe reserve practices concerning the following:

Waiver of deduction of deferred fractional premiums upon death of insured;
Return of portion of final premium for periods beyond the date of death; and

Note if any surrender value is promised in excess of the reserve as legally computed.

B. State methods employed in the valuation of substandard policies.

C. State the amount of insurance, if any, for which the gross premiums are less than the net premiums according to the standard of valuation required by this state. If not reported in Exhibit 8, Section G, Line 10700001, state the amount of reserves and indicate where reported.
D. Have the Tabular Interest (Page 7, Part A, Line 4), Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) and Tabular Cost (Page 7, Part A, Line 9) been determined by formula as described for these lines in the instructions for Page 7 or from the basic data for such items?

E. Describe the method of determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3.

F. Disclose the nature of significant other increases (net) under Page 7, Part B, Line 5.

Illustration:

A. The Company waives deduction of deferred fractional premiums upon death of insured and returns any portion of the final premium beyond the date of death. Surrender values are not promised in excess of the legally computed reserves.

B. Extra premiums are charged for substandard lives for policies issued prior to July 1, 19__, plus the gross premium for a rated age.

Mean reserves are determined by computing the regular mean reserve for the plan at the rated age and holding, in addition, one-half (1/2) of the extra premium charge for the year. Policies issued after July 1, 19__, for substandard lives, are charged an extra premium plus the regular premium for the true age. Mean reserves are based on appropriate multiples of standard rates of mortality.

C. As of December 31, 19__, the Company had $__________ of insurance in force for which the gross premiums are less than the net premiums according to the standard valuation set by the State of ________________. Reserves to cover the above insurance totaled $__________ at year-end and are reported in Exhibit 8, Sections A and B.

D. The Tabular Interest (Page 7, Part A, Line 4) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

The Tabular Less Actual Reserve Released (Page 7, Part A, Line 5) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of reserves and the actual reserves released).

The Tabular Cost (Page 7, Part A, Line 9) has been determined by formula as described in the instructions for Page 7 (or, alternatively, from the basic data for the calculation of policy reserves).

E. For the determination of Tabular Interest on funds not involving life contingencies under Page 7, Part B, Line 3, for each valuation rate of interest, the tabular interest is calculated as one hundredth of the product of such valuation rate of interest times the mean of the amount of funds subject to such valuation rate of interest held at the beginning and end of the year of valuation. The total amount of all such products is entered under Page 7, Part B, Line 3.
F. The details for “Other Increases” (net) under Page 7, Part B, Line 5 are:

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<th>TOTAL</th>
<th>1</th>
<th>2</th>
<th>ORDINARY</th>
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<th>GROUP</th>
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<td></td>
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<td></td>
<td>Annuities</td>
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<tr>
<td>5.99 Total</td>
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11. Analysis of Annuity Actuarial Reserves and Deposit Liabilities by Withdrawal Characteristics

Instruction:

Disclose the amount of annuity actuarial reserves and deposit liabilities by withdrawal characteristics as follows:

1. Subject to discretionary withdrawal:
   1.1 – With market value adjustment.
   1.2 – At book value less current surrender charge of 5% or more.
   1.3 – At market value.
   1.4 – Total with adjustment or at market value.
   1.5 – At book value without adjustment (minimal or no charge or adjustment).

2. Not subject to discretionary withdrawal.

3. Total (gross).

4. Reinsurance ceded.

5. Total (net) (3) – (4).

Reconcile the total annuity reserves and deposit fund liabilities amount disclosed in this note to the appropriate sections of Exhibit 8 and Exhibit 10, Line 19, Column 1 of the Life, Accident & Health Annual Statement and the corresponding lines in the Separate Accounts Statement.

A. Withdrawal Characteristic Classification Instructions:

1. Classify annual statement liabilities as “subject to discretionary withdrawal with market value adjustments” (1.1 above) where withdrawal of funds is payable at all times, or prior to specified maturity dates where such dates are more than one year after the statement date and:

   (a) In a lump sum with adjustments to reflect general changes in interest rates, or asset values since receipt of funds by the insurer. The adjustments either may be based on the insurer’s own investment experience with an assumed duration to the average maturity of the
underlying assets, or related to an index, or related to the maturity date of the liability; or

(b) In installments over five years or more, with or without a reduction in the interest rate during the installment period.

2. Classify annual statement liabilities as “subject to discretionary withdrawal at book value less surrender charge” (1.2 above) where the withdrawal of funds is payable at all times, or at any time within one year from the statement date in a lump sum subject to a current fixed surrender charge of 5% or more and it does not contain a meaningful bail out rate as provided in (4)(d) below.

3. Classify annual statement liabilities as “subject to discretionary withdrawal at market value” (1.3 above) where the withdrawal of funds is payable at current market value of the assets supporting the liabilities, the assets are stated at current market value, and the liabilities are stated at the current market value or per unit value of the assets supporting the liabilities. These liabilities are for contracts where the customer bears the entire investment risk.

4. Classify all other annual statement liabilities as “subject to discretionary withdrawal at book value (minimal or no charge or adjustments)” (1.5 above) where the withdrawal of funds is either payable at all times, or at any time (including a withdrawal on a scheduled payment date) within one year from the statement date and:

(a) In a lump sum without adjustment; or

(b) In installments over less than five years, with or without a reduction in interest rate during the installment period; or

(c) In a lump sum subject to a fixed surrender charge of less than 5%; or

(d) In a lump sum subject to a surrender charge, but such charge is waived if the credited rate falls below a specified “bail out” rate and the “bail out” rate is more than the maximum statutory valuation rate for life insurance policies for more than 20 years for new issues; or

(e) All others.

(The one year period from statement date covers both contracts with specified maturity dates on which withdrawal is permitted in accordance with (a) or (b) and contracts providing for a surrender charge which decreases by duration.)

B. Additional Instructions:

1. The annual statement liabilities to be covered by this note are both those actuarial reserves and deposit fund liabilities reported in the Life, Accident & Health Statement and those reported in the Separate Accounts Statement. Include actuarial reserves for annuities (other than disability annuities) and supplementary contracts with life contingencies reported in Exhibit 8; actuarial reserves for annuities, certain supplementary contracts without life contingencies, and deposit fund liabilities for annuities reported in Exhibit 10. Include all annuity actuarial reserves and deposit liabilities reported in the Separate Accounts Statement in this note.

2. Separate each actuarial reserve or deposit fund liability by its withdrawal characteristics, e.g., subject to discretionary withdrawal – with adjustment, etc. If a product contains more than one type of provision for either the individual policyholder or the participant to withdraw funds from the insurer, e.g., routine
withdrawals are at book value, other withdrawals are at market value, separate
the product’s reserves into the appropriate categories. Shared employer group or
jointly underwritten arrangements are to be reported as direct business.

3. Briefly describe the methods of estimation utilized to complete this disclosure if
more precise information was unavailable.

Illustration:

Withdrawal Characteristics of Annuity Actuarial
Reserves and Deposit Liabilities

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount</td>
<td>% of Total</td>
</tr>
</tbody>
</table>

1. Subject to discretionary withdrawal:
   1.1 – With market value adjustment $\_
   1.2 – At book value less current surrender
         charge of 5% of more
   1.3 – At market value
   1.4 – Total with adjustment or at market value
   1.5 – At book value without adjustment
         (minimal or no charge or adjustment)

2. Not subject to discretionary withdrawal

3. Total (gross)

4. Reinsurance ceded

5. Total (net)* (3) – (4) $\_

*Reconciliation of total annuity actuarial reserves and deposit fund liabilities.

Life & Accident & Health Annual Statement:

6. Exhibit 8, Section B, Total (net) $ \_
7. Exhibit 8, Section C, Total (net) 
8. Exhibit 10, Line 19, Column 1 
9. Subtotal 

Separate Accounts Annual Statement:

10. Exhibit 6, Line 0299999, Column 2 
11. Exhibit 6, Line 0399999, Column 2 
12. Page 3, Line 3 
13. Subtotal 
14. Combined Total $\_

12. Premium and Annuity Considerations Deferred and Uncollected

Instruction:

If the company has reported on Page 2, life insurance premiums and annuity considerations
deferred and uncollected on policies in force December 31 of current year, show separately the
amounts and the loading excluded for each of the following lines of business: industrial business,
ordinary new business, ordinary renewal, credit life, group life, and group annuity.
Deferred and uncollected life insurance premiums and annuity considerations as of December 31, 19XX, were as follows:

<table>
<thead>
<tr>
<th>Type</th>
<th>(1) Gross</th>
<th>(2) Net of Loading</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Industrial</td>
<td>$__________</td>
<td>$__________</td>
</tr>
<tr>
<td>ii. Ordinary new business</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>iii. Ordinary renewal</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>iv. Credit Life</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>v. Group Life</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>vi. Group Annuity</td>
<td>__________</td>
<td>__________</td>
</tr>
<tr>
<td>vii. Totals</td>
<td>$__________</td>
<td>$__________</td>
</tr>
</tbody>
</table>

13. Ceded Reinsurance Report

Section 1 – General Interrogatories

A. Are any of the reinsurers, listed in Schedule S as non-affiliated, owned in excess of 10% or controlled, either directly or indirectly, by the company or by any representative, officer, trustee, or director of the company? Yes ( )       No ( )  If yes, give full details.

B. Have any policies issued by the company been reinsured with a company chartered in a country other than the United States (excluding U.S. Branches of such companies) which is owned in excess of 10% or controlled directly or indirectly by an insured, a beneficiary, a creditor or an insured or any other person not primarily engaged in the insurance business? Yes ( )       No ( )  If yes, give full details.

Section 2 – Ceded Reinsurance Report – Part A

A. Does the company have any reinsurance agreements in effect under which the reinsurer may unilaterally cancel any reinsurance for reasons other than for nonpayment of premium or other similar credits? Yes ( )       No ( )

i) If yes, what is the estimated amount of the aggregate reduction in surplus of a unilateral cancellation by the reinsurer as of the date of this statement, for those agreements in which cancellation results in a net obligation of the company to the reinsurer, and for which such obligation is not presently accrued? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $________________

ii) What is the total amount of reinsurance credits taken, whether as an asset or as a reduction of liability, for these agreements in this statement? $________________

B. Does the company have any reinsurance agreements in effect such that the amount of losses paid or accrued through the statement date may result in a payment to the reinsurer of amounts which, in aggregate and allowing for offset of mutual credits from other reinsurance agreements with the same reinsurer, exceed the total direct premium collected under the reinsured policies? Yes ( )       No ( )  If yes, give full details.

Section 3 – Ceded Reinsurance Report – Part B

A. What is the estimated amount of the aggregate reduction in surplus, (for agreements other than those under which the reinsurer may unilaterally cancel for reasons other than...
for nonpayment of premium or other similar credits that are reflected in Section 2 above) of termination of ALL reinsurance agreements, by either party, as of the date of this statement? Where necessary, the company may consider the current or anticipated experience of the business reinsured in making this estimate. $_________________

B. Have any new agreements been executed or existing agreements amended, since January 1 of the year of this statement, to include policies or contracts which were in force or which had existing reserves established by the company as of the effective date of the agreement? Yes ( ) No ( )

If yes, what is the amount of reinsurance credits, whether an asset or a reduction of liability, taken for such new agreements or amendments? $__________________

14. Uncollectible Reinsurance

Instruction:

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

i. The Company has written off in the current year reinsurance balances due from the companies listed below, the amount of: $____

which is reflected as:

   ii. Losses incurred $____
   iii. Loss adjustment expenses incurred $____
   iv. Premiums earned $____
   v. Other $____

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$</td>
</tr>
<tr>
<td>ZYX</td>
<td>$</td>
</tr>
</tbody>
</table>

15. Commutation of Ceded Reinsurance

Instruction:

Describe commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

1. Claims incurred;
2. Claim adjustment expenses incurred;
3. Premiums earned;
4. Other.

Illustration:

Commutation of Reinsurance Reflected in Income and Expenses.
The company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $_____
ii. Loss adjustment expenses incurred $_____
iii. Premiums earned $_____
iv. Other $_____

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$____</td>
</tr>
<tr>
<td>ZYX</td>
<td>$____</td>
</tr>
</tbody>
</table>

Generally Accepted Accounting Principles

19. FAS 113 contains the following guidance with respect to reporting assets and liabilities related to reinsurance transactions:

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding company’s liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise’s financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of offset exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

20. FAS 113 contains the following guidance with respect to reinsurance of long-duration contracts:

Reinsurance of Long-Duration Contracts

12. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk as that concept is contemplated in Statement 60 and FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.

13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts
that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

**Recognition of Revenues and Costs for Reinsurance of Long-Duration Contracts**

25. **Amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long duration or short duration. The cost shall be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long duration, or over the contract period of the reinsurance if the reinsurance contract is short duration. Determining whether a contract that reinsures a long-duration insurance contract is long duration or short duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts. The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.**

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Admitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 52 - Deposit-Type Contracts
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17 - Other Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 24 - Reinsurance (including appendices A and B)
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies, Notes to Financial Statements and Schedule S

**Generally Accepted Accounting Principles**
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- FASB Statement No. 5, *Accounting for Contingencies*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 75

Property and Casualty Reinsurance

STATUS
Finalized March 16, 1998

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Reinsurance is the assumption by an insurer of all or part of a risk undertaken originally by another insurer. Current statutory guidance on the accounting for property and casualty reinsurance is contained in Chapters 7, 8, and 22 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual).

2. GAAP guidance on the accounting for property and casualty reinsurance is primarily contained in FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FAS 113) and Emerging Issues Task Force Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises* (EITF 93-6). In certain instances, FAS 113 differs from the current statutory guidance.

3. The purpose of this issue paper is to establish statutory accounting principles for property and casualty reinsurance that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper applies to property and casualty contracts as defined in Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force. The provisions of Chapter 8 of the P&C Accounting Practices and Procedures Manual that relate to reinsurance recoverable on paid losses (included in paragraph 16 of this issue paper) and Chapter 22 of the P&C Accounting Practices and Procedures Manual (Chapter 22) are adopted as the statutory accounting principles for property and casualty reinsurance except as modified in paragraph 5 below. In addition, the Annual Statement Instructions that require reinsurance disclosures in notes 11, 12, 13, 15, 16 and 17 to the Annual Statement are also adopted as statutory accounting principles.

5. Ceded reinsurance premiums payable (net of ceding commission) shall be classified as a liability. Consistent with Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76), ceded reinsurance premiums payable may be deducted from amounts due from the reinsurer, such as amounts due on assumed reinsurance, when a legal right of offset exists.

6. Notwithstanding the fact that reinsurance recoverables on paid losses may meet the criteria for offsetting under the provisions of Issue Paper No. 76, reinsurance recoverables on paid losses are to be reported as an asset without any available offset.

7. The Property and Casualty Annual Statement Instructions to Schedule F provide for a minimum reserve for uncollectible reinsurance with an additional reserve required if a company’s experience indicates that a higher amount should be provided. The excess reserve over the minimum amount should be charged through the Statement of Operations by reversing the accounts previously utilized to establish the reinsurance recoverable.
DISCUSSION

8. Statutory accounting for property and casualty reinsurance was recently revised through amendments to Chapter 22. These amendments adopted FAS 113 with modification and EITF 93-6 with modification. This issue paper rejects AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance. As a result, the statutory accounting principles established by this issue paper are generally consistent with GAAP except for the following significant exceptions:

a. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be presented as a contra-liability netted against the liability for gross losses and loss adjustment expenses. Under GAAP, these recoverables are reported as assets.

b. Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of unearned premiums whereas under GAAP, the unamortized portion of the amount paid for prospective reinsurance is recorded as a prepaid asset.

c. The gain created by a retroactive reinsurance contract because the amount paid to the reinsurer is less than the gross liabilities for losses and loss adjustment expenses ceded to the reinsurer is reported in the income statement as a write-in gain in “other income” by the ceding entity and a write-in loss by the assuming entity. The gain created by a retroactive reinsurance contract is restricted as a special surplus account until the actual retroactive reinsurance recovered is in excess of the consideration paid. Under GAAP, gains arising from retroactive reinsurance contracts are deferred and recognized over the settlement period.

d. Statutory accounting requires that a liability be established through a provision reducing surplus for unsecured reinsurance recoverables from unauthorized reinsurers and for certain overdue balances due from authorized reinsurers. Under GAAP, no such liability is required. However, both statutory accounting and GAAP require an assessment of the collectibility of recorded reinsurance recoverables.

e. Some reinsurance treaties contain adjustable features that provide for adjustment of commission, premium or amount of coverage, based on loss experience. Chapter 22 and EITF 93-6 require recognition of these adjustable features in the period in which the loss event(s) giving rise to the adjustment occurs. Under EITF 93-6, the asset or liability arising from the adjustable feature may be computed under the assumption that the treaty will be terminated prior to the end of its term if such termination is permitted under the contract and to do so results in a lower asset or liability (“lesser of” provision). Statutory accounting requires that the asset or liability arising from the adjustable feature be computed based on experience to date under the contract, and the impact of early termination may only be considered at the time the contract has actually been terminated.

f. Structured settlements are addressed in Issue Paper No. 65 - Property and Casualty Contracts (Issue Paper No. 65). Statutory accounting and FAS 113 are consistent in accounting for structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the payee and the reporting entity has been released from its obligation. FAS 113 distinguishes structured settlement annuities where the claimant is the payee and a legally enforceable release from the reporting entity’s liability is obtained from those where the claimant is the payee but the reporting entity has not been released from its obligation. GAAP requires the deferral of any gain resulting from...
the purchase of a structured settlement annuity where the reporting entity has not been released from its obligation.

9. Reinsurance recoverables on paid losses and loss adjustment expenses are reported as an asset under both statutory accounting and GAAP. Reinsurance recoverables on unpaid losses and loss adjustment expenses also meet the statutory definition of an asset established in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets; however, this asset will continue to be presented as a contra-liability in statutory financial statements because a change to “gross” presentation would necessitate extensive changes in and restatement of the reporting of ceded reinsurance in schedules and exhibits of the Annual Statement. This “net” presentation is consistent with the reporting of salvage and subrogation established by Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses. Statutory requirements for offsetting and netting are addressed in Issue Paper No. 76.

10. The statutory reporting of amounts paid for prospective reinsurance contracts that have not been amortized to income described in subparagraph 8b is consistent with the “net” reporting discussed in paragraph 9.

11. The statutory accounting for gains and losses resulting from retroactive reinsurance contracts is consistent with the Statement of Concepts which states:

   The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance.

12. The statutory requirement to establish a liability, Provision for Reinsurance, for unsecured reinsurance recoverables from unauthorized reinsurers and overdue balances from authorized reinsurers is contained in the Instructions to the Property and Casualty Annual Statement, Schedule F - Part 7 which are adopted in this issue paper as part of Chapter 22. The Schedule F provision for reinsurance was maintained as part of statutory accounting as an added measure of conservatism consistent with the Statement of Concepts. Maintaining this conservatism was deemed appropriate as there is no other apparent independent measure of the adequacy of the estimates. Maintaining this requirement is in contrast to the elimination of the excess statutory reserve in Issue Paper No. 65. It was determined that sufficient information is available to regulators regarding the adequacy of reserves such that the additional conservatism provided by the excess statutory reserve is no longer justified. Paragraph 7 of this issue paper requires that any portion of reinsurance recoverables deemed to be uncollectible as a result of a reporting entity’s experience being higher than the amounts provided by the minimum Schedule F provision shall be written off through a charge to operations, whereas current statutory accounting would require any additional amount to be added to the Schedule F provision resulting in a direct charge to surplus. This change was made to reflect known losses as charges to operations as opposed to direct charges to surplus.

13. Statutory accounting requires the calculation related to adjustable features to be computed based on experience to date because, from a regulatory standpoint, it is improper to recognize the favorable impact of early termination of the contract until such time as the contract is actually terminated.

14. Ceded reinsurance premiums payable are no longer deducted from agents’ balances and uncollected premiums because this payable meets the definition of a liability as established in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets and it does not meet the criteria for offsetting under the provisions of Issue Paper No. 76.

Drafting Notes/Comments
- Reinsurance for life and accident and health contracts is addressed in Issue Paper No. 74 - Life and Accident and Health Reinsurance.
Structured settlements for property and casualty insurers are addressed in Issue Paper No. 65 - Property and Casualty Contracts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
15. Chapter 7 of the P&C Accounting Practices and Procedures Manual, Agents’ Balance or Uncollected Premiums, provides the following guidance on ceded premiums payable:

Ceded Reinsurance Premiums Payable

Ceded reinsurance premiums payable are those premiums that are due to other insurance companies for coverages purchased to reduce the ceding company’s liability. Ceded reinsurance premiums payable are deducted from agents’ balances or uncollected premiums in the balance sheet. (See Chapter 22 - Reinsurance.)

16. Chapter 8 of the P&C Accounting Practices and Procedures Manual provides the following guidance on reinsurance recoverable on paid losses:

(f) Funds held or deposited with reinsured companies, whether they are premiums withheld for unearned premium and outstanding loss reserves or advances for loss payments, are admitted assets provided they do not exceed the liabilities they secure and provided the reinsured is solvent. Those funds which are in excess of the liabilities, and any funds held by insolvent reinsureds, should be nonadmitted.

(h) Reinsurance recoverable on loss payments is an admitted asset. Unauthorized reinsurance is included in this asset and reflected separately as a liability to the extent required. Penalty for overdue on authorized companies will be reflected as a liability. (See Chapter 22 - Reinsurance.)

17. The guidance for calculating the penalty for unauthorized reinsurance and the penalty for overdue balances from authorized reinsurers is contained in the Annual Statement Instructions.

18. The current statutory accounting for property and casualty reinsurance is contained in the P&C Accounting Practices and Procedures Manual, Chapter 22, Reinsurance. Chapter 22 provides the following guidance with respect to the determination of whether a reinsurance contract qualifies for reinsurance accounting:

Reinsurance Contracts Must Include Transfer of Risk

The essential ingredient of a reinsurance contract is the shifting of risk. The essential element of every true reinsurance contract is the undertaking by the reinsurer to indemnify the ceding insurer (i.e., reinsured company), not only in form but in fact, against loss or liability by reason of the original insurance. Unless the so-called reinsurance contract contains this essential element of risk transfer, no credit whatsoever shall be allowed on account thereof in any accounting or financial statement of the ceding insurer.

Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous - the possibility of adverse events occurring is outside the control of the insured.

Determining whether a contract with a reinsurer provides indemnification against loss or liability (transfer of risk) relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding company and related reinsurers. A complete understanding includes an evaluation of all contractual features that (a) limit the amount of
insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract) or (b) delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Indemnification of the ceding company against loss or liability relating to insurance risk in reinsurance requires both of the following:

1. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

2. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Implicit in this condition is the requirement that both the amount and timing of the reinsurers payments depend on and directly vary with the amount and timing of claims settled by the ceding company. Contractual provisions that delay timely reimbursement to the ceding company would prevent this condition from being met.

The ceding company’s evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming companies under reasonably possible outcomes, without regard to how the individual cash flows are described or characterized. An outcome is reasonably possible if its probability is more than remote. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. A constant interest rate shall be used in determining those present values because the possibility of investment income varying from expectations is not an element of insurance risk. Judgment is required to identify a reasonable and appropriate interest rate.

Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in the above paragraph, with the present value of the amounts paid or deemed to have been paid to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding company shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. In this narrow circumstance, the reinsurers economic position is virtually equivalent to having written the insurance contract directly. This condition is met only if insignificant insurance risk is retained by the ceding company on the reinsured portions of the underlying insurance contracts, so that the reinsurers exposure to loss is essentially the same as the insurers.

Payment schedules and accumulating retentions from multiple years are contractual features inherently designed to delay the timing of reimbursement to the ceding company. Regardless of what a particular feature might be called, any feature that can delay timely reimbursement violates the conditions for reinsurance accounting. Transfer of insurance risk requires that the reinsurers payment to the ceding company depend on and directly vary with the amount and timing of claims settled under the reinsured contracts. Contractual features that can delay timely reimbursement prevent this condition from being met. Therefore, any feature that may affect the timing of the reinsurers reimbursement to the ceding company should be closely scrutinized.

19. The effective date for adopting the accounting and reporting requirements outlined in paragraph 18 are contained in Chapter 22 as follows:

Effective Date: Transition Rule
The revised accounting and reporting practices set forth in this chapter that were adopted on September 18, 1994 shall be effective for all accounting periods beginning on or after January 1, 1995 and shall apply to: (a) reinsurance contracts entered into, renewed, or amended on or after January 1, 1994, (an amendment is any revision or adjustment of contractual terms, but the payment of premiums or reimbursement of losses recoverable under the contract shall not constitute an amendment); and (b) reinsurance contracts in force on January 1, 1995 which cover losses occurring or claims made on or after that date on policies reinsured under such contracts.

The revised accounting and reporting provisions shall not apply to: (a) reinsurance contracts which cover only losses occurring or claims made before January 1, 1994 and which were entered into before January 1, 1994, and were not subsequently renewed or amended; and (b) reinsurance contracts that expired before, and were not renewed or amended after, January 1, 1995.

Previously reported amounts relating to contracts to which these revised accounting practices are not applicable shall not be restated. However, for accounting periods commencing on and after January 1, 1995, balances relating to contracts which were entered into, renewed or amended on or after January 1, 1994 and which do not transfer insurance risk shall be reclassified as deposits and shall be accounted for and reported in the manner described under the caption "Reinsurance Contracts Must Include Transfer of Risk".

Insurers may elect to comply with these revised accounting practices for accounting periods commencing before January 1, 1995.

20. Chapter 22 requires the following accounting for reinsurance contracts that do not qualify for reinsurance accounting (i.e., do not transfer insurance risk):

To the extent that a reinsurance contract does not, despite its form, transfer both components of insurance risk, all or part of the contract shall be accounted for and reported as deposits in the NAIC annual and interim financial statements in the following manner:

1. At the outset of the reinsurance contract the net consideration paid by the ceding company (premiums less commissions or other allowances) shall be recorded as a deposit on the ceding company’s books and as a liability on the assuming company’s books. The deposit may be reported as an admitted asset in the ceding company’s annual statement (as a write-in item for other than invested assets) if (a) the assuming company is licensed, accredited or otherwise qualified in the ceding company’s state of domicile under Section 1 of the NAIC Model Law on Credit for Reinsurance or (b) there are funds held by or on behalf of the ceding company which meet the requirements of Section 2 of that law. Throughout the life of the contract receipts and disbursements shall be recorded through the deposit/liability accounts. When the contract is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded as other income or loss.

2. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company’s balance sheet, schedules and exhibits.

3. The assuming company shall record net consideration to be returned to the ceding company as liabilities.

21. Chapter 22 requires the following accounting for reinsurance contracts that qualify for reinsurance accounting (i.e., transfer insurance risk). The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at its December 13, 1995 meeting. This guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.
Accounting for Reinsurance

Reinsurance recoverables shall be recognized in a manner consistent with the liabilities (including estimated amounts for claims incurred but not reported) relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities. Accounting for members of a reinsurance pool shall follow the accounting for the pool member which wrote the underlying policy.

Accounting for reinsurance depends on whether the contract is considered prospective or retroactive. Prospective reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. Retroactive reinsurance is reinsurance in which a reinsurer agrees to reimburse a ceding company for liabilities incurred as a result of past insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

The distinction between prospective and retrospective reinsurance contracts is based on whether the contract reinsures future or past insured events covered by the underlying insurance policies. For example, in occurrence-based insurance, the insured event is the occurrence of a loss covered by the insurance contract. In claims-made insurance, the insured event is the reporting to the insurer, within the period specified by the policy, of a claim for a loss covered by the insurance contract. A claims-made reinsurance contract that reinsures claims asserted to the reinsurer in a future period as a result of insured events that occurred prior to entering into the reinsurance contract is a retroactive contract. (However, a reinsurance contract that reinsures claims reported to an insurer that are covered under currently effective claims-made insurance policies is a prospective reinsurance contract.)

It is not uncommon for a reinsurance arrangement to be initiated before the beginning of a policy period but not finalized until after the policy period begins. Whether there was agreement in principle at the beginning of the policy period and, therefore, the contract is substantively prospective must be determined based on the facts and circumstances. However, except as respects business assumed by a U.S. reinsurer from ceding companies domiciled outside the U.S. and not affiliated with such reinsurer, or business assumed by a U.S. reinsurer where either the lead reinsurer or a majority of the capacity on the contract is domiciled outside the U.S. and is not affiliated with such reinsurer, if a contract entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and must be accounted for as a retroactive reinsurance contract. This presumption shall not apply to: (a) facultative reinsurance contracts; nor to (b) reinsurance contracts with more than one reinsurer which are signed by the lead reinsurer (i.e. the reinsurer setting the terms of the contract for the reinsurers) within nine months after the commencement of the policy period covered by the reinsurance contract; nor to (c) reinsurance contracts with more than one reinsurer (whether signed by the lead reinsurer or not) which were entered into, renewed or amended on or before December 31, 1996, (and which were not renewed or amended after that date) if reinsurers representing more than 50% of the capacity on the contract have signed cover notes, placement slips or similar documents describing the essential terms of coverage and exclusions within nine months after the commencement of the policy period covered by the reinsurance arrangement.

When practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met.
Accounting for Prospective Reinsurance Contracts

Amounts paid for prospective reinsurance that meets the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated reinsurance recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current periods statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, reinsurance recoverables on loss and loss adjustment expense payments, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

Accounting for Retroactive Reinsurance Contracts

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for and reported in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.

2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.

3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as "retroactive reinsurance reserve ceded or assumed", recorded as a contra-liability by the ceding company and as a liability by the assuming company.

4. The ceding company must, by write-in item on Page 3, restrict surplus resulting from any retroactive reinsurance as a special surplus fund, designated as "special surplus from retroactive reinsurance account".

5. The surplus gain from any retroactive reinsurance may not be classified as unassigned funds [considered earned surplus] until such time as the actual retroactive reinsurance-recovered is in excess of the consideration paid.

6. The "special surplus from retroactive reinsurance account" for each respective retroactive reinsurance contract shall be reduced at the time the ceding company begins to recover funds from the assuming company in amounts exceeding the consideration paid by the ceding company under such agreement, or adjusted as provided in paragraph 10 below.

7. For each agreement, the reduction in the "special surplus from retroactive reinsurance" account must be limited to the lesser of:

   (a) the actual amount recovered in excess of consideration paid; or
(b) the initial surplus gain resulting from the respective retroactive reinsurance contract.

Any remaining balance in the “retroactive reinsurance reserve ceded or assumed” account derived from any such agreement must be returned to unassigned funds upon elimination of all policy obligations subject to the retroactive reinsurance contract.

8. The ceding company shall report the initial gain arising from a retroactive reinsurance transaction (i.e., the difference between the consideration paid to the reinsurer and the total reserves ceded to the reinsurer) as a write-in item on Page 4, to be identified as “Retroactive Reinsurance Gain” and included under “Other Income” in the Underwriting and Investment Exhibit Statement of Income.

9. The assuming company shall report the initial loss arising from a retroactive reinsurance transaction, as defined in the preceding paragraph 8., as a write-in item on Page 4, to be identified as Retroactive Reinsurance Loss and included under Other Income in the Underwriting and Investment Exhibit Statement of Income.

10. Any subsequent increase or reduction in the total reserves ceded under a retroactive reinsurance agreement shall be reported in the manner described in the preceding paragraphs 8. and 9., in order to recognize the gain or loss arising from such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry on Page 3 and the pertinent entry in the Notes to the Financial Statement shall be adjusted, upward or downward, to reflect such increase or reduction in reserves ceded. The “Special Surplus from Retroactive Reinsurance Account” write-in entry must be equal to or less than the total ceded reserves under all retroactive reinsurance agreements in-force as of the date of the financial statement. Special surplus arising from a retroactive reinsurance transaction shall be considered to be earned surplus (i.e., transferred to Unassigned Funds) only when cash recoveries from the assuming company exceed the consideration paid by the ceding company as respects such retroactive reinsurance transaction.

11. Each retroactive reinsurance contract shall be included in the Notes to Financial Statements relating to “Ceded or Assumed Unpaid Loss and Loss Adjustment Expenses”.

12. The consideration paid for a retroactive reinsurance contract shall be reported as a decrease in Exhibit 3 ledger assets by the ceding company and as an increase in Exhibit 3 ledger assets by the assuming company (as a write-in item).

(For an illustration of ceding company accounting entries see Question 33 in Appendix A.)

This procedure regarding accounting for retroactive reinsurance contracts shall not apply to the following types of contracts (which shall be accounted for as prospective reinsurance contracts):

1. Structured settlement annuities for individual claims purchased to implement settlements of policy obligations;

2. Novations, i.e. (a) transactions in which the original direct insurer’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated or (b) transactions in which the original assuming company’s obligations are completely extinguished, resulting in no further exposure to loss arising on the business novated, provided that (i) the parties to the transaction are not affiliates (or if affiliates, that the transaction has the prior approval of the domiciliary regulators of the parties) and (ii) the accounting for
the original reinsurance agreement will not be altered from retroactive to prospective

3. The termination of, or reduction in participation in, reinsurance treaties entered into in the ordinary course of business; or

4. Intercompany reinsurance contracts, and any amendments thereto, among companies 100% owned by a common parent or ultimate controlling person provided there is no gain in surplus as a result of the transaction.

Except for its accounting and reporting provisions, this procedure regarding retroactive reinsurance shall not apply to transactions transferring liabilities in connection with a court-ordered rehabilitation, liquidation or receivership with written approval of the ceding company’s domiciliary commissioner.

Retroactive reinsurance contracts resulting in surplus gain to the ceding company (with or without risk transfer) entered into between affiliates or between insurers “under common control” (as those terms are defined in the NAIC Model Insurance Holding Company Regulatory Act) shall be reported in annual and interim statements as follows:

1. The consideration paid by the ceding company shall be recorded as a deposit and reported as a non-admitted asset in Exhibit 1; and

2. No deduction shall be made from loss and loss adjustment expense reserves on the ceding company’s balance sheet, schedules and exhibits.

Required Terms for Reinsurance Contracts

In addition to credit for reinsurance requirements applicable to reinsurance transactions generally, no credit or deduction from liabilities shall be allowed for reinsurance recoverable in annual or interim statements required to be filed by the ceding company where the agreement was entered into after the effective date of these requirements unless each of the following conditions is satisfied:

1. The contract must contain an acceptable insolvency clause.

2. Recoveries due the ceding company must be available without delay for payment of losses and claim obligations incurred under the agreement, in a manner consistent with orderly payment of incurred policy obligations by the ceding company.

3. The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly, from the reinsurer to the ceding company or from the ceding company to the reinsurer.

4. The agreement must provide for reports of premiums and losses, and payment of losses, no less frequently than on a quarterly basis. The report of premiums and losses shall set forth the ceding company’s total loss and loss expense reserves on the policy obligations subject to the agreement, so that the respective obligations of the ceding company and reinsurer will be recorded and reported on a basis consistent with this manual.

5. With respect to retroactive reinsurance contracts the following additional conditions apply. The consideration to be paid by the ceding company for the retroactive reinsurance must be a sum certain stated in the agreement. Direct or indirect compensation to the ceding company or reinsurer is prohibited. Any provision for subsequent adjustment on the basis of actual experience in regard to policy obligations transferred, or on the basis of any other formula, is prohibited in connection with a retroactive reinsurance transaction, except that
provision may be made for the ceding company’s participation in the reinsurer’s ultimate profit, if any, under the agreement. A retroactive reinsurance contract may not be canceled or rescinded without the approval of the commissioner of the domiciliary state of the ceding company.

Characteristics of Reinsurance Contracts

Each reinsurance contract may be individually drafted. Commonly included contract provisions that may affect accounting practices include:

1. Reporting responsibility of the ceding insurer. Should be clearly spelled out both as to details required and time schedules.

2. Payment terms. Time schedules, currencies intended and the rights of the parties to withhold funds should be established.

3. Payment of premium taxes. Customarily the responsibility of the ceding company, a recital of nonliability of the reinsurer may be found.

4. Termination. May be on a “cut-off” or “run-off” basis. A “cut-off” provision stipulates that the reinsurer shall not be liable for loss as a result of occurrences taking place after the date of termination. A “run-off” provision stipulates that the reinsurer shall remain liable for loss under reinsured policies in force at the date of termination as a result of occurrences taking place after the date of termination until such time as the term of the policy expires.

5. Insolvency clause. Should provide for the survival of the reinsurer’s obligations in the event of insolvency of the ceding company, without diminution because of the insolvency.

Reinsurance contracts shall not permit entry of an order of rehabilitation or liquidation to constitute an anticipatory breach by the insurer nor grounds for retroactive revocation or retroactive cancellation of any contracts of the insurer.

Reinsurance Assumed

The segregation of premiums, losses and expenses arising from reinsurance assumed transactions is required for the Underwriting and Investment Exhibit of the annual statement.

Non-proportional assumed reinsurance transactions should be included in the reinsurance lines of business in the annual statement under four subcategories while all proportional reinsurance (first dollar pro-rata reinsurance) must be allocated to the appropriate lines of business.

Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as “Agents’ balances or uncollected premiums”. Where the ceding insurer withholds premium funds pursuant to the terms of the reinsurance contract, such assets should be shown by the assuming company as “Funds held by or deposited with reinsured companies”. Reinsurance premiums more than 90 days overdue should not be included as receivable except (a) to the extent the assuming insurer maintains unearned premium and loss reserves as to the ceding insurer, under normal principles of offset accounting, or (b) where the ceding insurer is licensed and in good standing in assuming insurer’s state of domicile. Reinsurance premiums are due pursuant to the original contract terms (as the contract stood on the date of execution); in the absence of a specific contract date, reinsurance premiums will be deemed due thirty (30) days after the date on which (1) notice or demand of premium due is provided to the ceding insurer or (2) the assuming insurer books the premium (See Chapter 9 - Nonadmitted Assets).

A lag will develop between the time of the entry of the underlying policy transaction on the books of the ceding insurer and the transmittal of information and its entry on the books of the assuming
company. Assuming companies shall estimate such unreported premiums and related costs to the extent necessary to prevent material distortions in the loss development contained in the assuming company’s annual statement schedules where calendar year premiums are compared to accident year losses.

Amounts payable by reinsurers on losses are generally classified in the annual statement as unpaid losses. Assumed reinsurance payable on paid losses should be classified as a separate liability item on the balance sheet. IBNR losses on assumed reinsurance business are netted with ceded losses on the balance sheet but are shown separately by annual statement line of business in the Underwriting and Investment Exhibit.

**Reinsurance Ceded**

The Underwriting and Investment Exhibit of the annual statement presents segregated data on the premiums, losses and expenses from reinsurance ceded transactions in a manner similar to reinsurance assumed.

Ceded reinsurance transactions should be included in the annual statement line of business which relates to the direct or assumed transactions creating the cession or retrocession.

Premiums due reinsurers ("ceded balances payable") are shown as contra assets contained in “Agents’ balances or uncollected premiums.” Amounts that are withheld by the ceding company from sums that would otherwise be payable under the reinsurance contract are reportable as “Funds held by company under reinsurance treaties.”

**Adjustable Feature/Retrospective Rating**

Reinsurance treaties may provide for adjustment of commission, premium, or amount of coverage, based on loss experience. Examples are:

1. **Commission Adjustments:**

   Contingent or Straight Profit—The reinsurer returns to the ceding company a stipulated percentage of the profit produced by the business assumed from the ceding insurer. Profit may be calculated for any specified period of time, but the calculation is often based on an average over a period of years.

   Sliding Scale—A provisional rate of commission is paid over the course of the treaty, with a final adjustment based on the experience of the business ceded under the treaty.

   An accrual shall be maintained for these adjustable features based upon the experience recorded for the period.

2. **Premium Adjustments:**

   The initial provisional or deposit premium is recalculated retrospectively, based on loss experience under the treaty during a specified period of time; the calculation is often based on an average over a period of years.

   If the reinsurance treaty incorporates an obligation on the part of the ceding company to pay additional premium to the assuming company based upon loss experience under the treaty, a liability in the amount of such additional premium shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to pay such additional premium occur(s). The assuming company shall recognize an asset in the same amount.
If the reinsurance treaty incorporates an obligation on the part of the assuming company to refund to the ceding company any portion of the consideration received by the assuming company based upon loss experience under the treaty, an asset in the amount of any such refund shall be recognized by the ceding company during the accounting period in which the loss event(s) giving rise to the obligation to make such refund occur(s). The assuming company shall recognize a liability in the same amount.

3. Adjustments in the Amount of Coverage:

The amount of coverage available for future periods is adjusted, upward or downward, based on loss experience under the treaty during a specified period of time.

If the reinsurance treaty incorporates a provision under which the reinsurance coverage afforded to the ceding company may be increased or reduced based upon loss experience under the treaty, an asset or a liability shall be recognized by the ceding company in an amount equal to that percentage of the consideration received by the assuming company which the increase or reduction in coverage represents of the amount of coverage originally afforded. Such asset or liability shall be recognized during the accounting period in which the loss event(s) (or absence thereof) giving rise to the increase or decrease in reinsurance coverage occur(s), and shall be amortized over all accounting periods for which the increased or reduced coverage is applicable. The term “consideration” shall mean, for this purpose, the annualized deposit premium for the period used as the basis for calculating the adjustment in the amount of coverage to be afforded thereafter under the treaty.

Effective Date

The accounting and reporting provisions set forth in paragraphs 1, 2 and 3 above shall be effective for all accounting periods beginning on or after January 1, 1996, and shall apply to reinsurance contracts entered into, renewed or amended on or after January 1, 1994.

Commissions

Commissions payable on reinsurance assumed business should be included as an offset to “Agents” Balances or Uncollected Premiums. Commissions receivable on reinsurance ceded business should be included as an offset to “Ceded Reinsurance Balances Payable”. (See Chapter 18 - Commissions.)

If the ceding commission paid under a non-proportional reinsurance contract exceeds the anticipated acquisition cost of the business ceded, the ceding company shall establish a liability, equal to the difference between the anticipated acquisition cost and the reinsurance commissions received, to be amortized pro rata over the life of the reinsurance contract.

Those reinsurance contracts drafted in form as pro rata but which, in fact, contain per loss deductibles to be retained by the ceding carrier shall be considered non-proportional for the purposes of the paragraph above.

Provision for Reinsurance

The liability “Provision for Reinsurance” is reflected on page three of the Annual Statement, and the change between years is recorded as a gain or loss directly to surplus.

The details of this calculation can be found in Schedule “F-Part 7” of the Annual Statement. The appropriate instructions for calculating this liability can be found in the Instructions to the Annual Statement.
This provision is calculated separately for unauthorized and authorized companies in Schedule F. An authorized reinsurer is one that is licensed, accredited or approved by the ceding insurers state of domicile; an unauthorized reinsurer is not so licensed, accredited or approved.

Disputed Items

Occasionally a reinsurer will question whether an individual claim is covered under a reinsurance contract or may even attempt to nullify an entire treaty. A ceding insurer, depending upon the individual facts, may or may not choose to continue to take credit for such disputed balances. The Annual Statement Instructions require notification of a dispute by a formal written communication from the reinsurer denying the validity of coverage. Additionally, the “Notes to Financial Statements” require footnote disclosure of material amounts and the status of disputed items. Furthermore, a ceding insurer may take no credit whatsoever for reinsurance recoverables in dispute with an affiliate.

Commutations

A commutation of a reinsurance contract is a transaction which results in the complete and final settlement and discharge of all present and future obligations between the parties arising out of the agreement.

Reasons for commuting reinsurance contracts often include: (1) perceived financial instability of the reinsurer, (2) inefficiencies associated with the runoff of longer tailed liabilities, (3) significantly different evaluation of ultimate loss costs or (4) the reinsurers withdrawal from the reinsurance marketplace.

In commutation agreements, the present value of the reinsurers estimated ultimate losses are paid by the reinsurer to the ceding insurer. The ceding insurer immediately establishes the ultimate loss reserve as its liability and the cash received as a negative paid loss, thus creating a reduction in policyholders surplus equal to the difference between the ultimate and present value of the loss reserve.

The reinsurer, on the other hand, has eliminated a loss reserve carried at ultimate cost for a cash payout calculated at present value. The result is an increase in policyholders surplus equal to the difference between the ultimate and present value of the loss reserves.

Committed balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

Uncollectible Reinsurance

Uncollectible reinsurance balances must be accounted for by writing them off through the accounts, exhibits and schedules in which they were originally recorded.

22. Chapter 22 requires the following disclosures with respect to reinsurance. The guidance for retroactive reinsurance contracts was revised by the Property Casualty Reinsurance Study Group at their December 13, 1995 meeting. This guidance was adopted by the membership of the NAIC at the March 1996 Plenary Session. Changes adopted have been underlined and struckthrough in this paragraph.

Reporting of Reinsurance Transactions

Ceded reinsurance disclosures in the Notes to Financial Statements of the annual statement indicates the impact on the insurers surplus if all its reinsurance were canceled. The effect of return commissions, sliding scale commissions, as well as minimum and maximum commissions, is required to be calculated and then measured as factors reducing surplus.

Portfolio reinsurance is the transfer of the entire liability of an insurer for in force policies or outstanding losses, or both, as respects a described segment of the insurers business. Loss
portfolio transfers are to be accounted for as retroactive reinsurance which is discussed earlier in this chapter.

A specific interrogatory requires information on reinsurance of risk accompanied by an agreement to release the reinsurer from liability, in whole or in part, from any loss that may occur on the risk or portion thereof.

A commonly accepted practice among affiliated insurers is the sharing of underwriting results ("pooling") in accordance with predetermined ratios. This is normally accomplished by a procedure whereby all affiliated insurers reinsure their direct business with the major insurers. Business is then retroceded to the affiliates so that each member of the group receives its predetermined share of the gross group business.

Detailed disclosure of certain reinsurance transactions is required in various notes to financial statements. These include retroactive reinsurance, unsecured reinsurance recoverables, reinsurance recoverables in dispute, write off of uncollectible reinsurance, and reinsurance commutations.

23. Chapter 22 provides the following guidance on the National Flood Insurance Program:

National Flood Insurance Program

This program was created by the Federal Emergency Management Agency (FEMA) and is designed to involve private insurers in a "write-your-own" (WYO) flood insurance program financially backed by FEMA at no risk to the insurer. To become a participating WYO company, the insurer signs a document with the Federal Insurance Administration (FIA) of the Federal Emergency Management Agency known as the Financial Assistance/Subsidy Arrangement.

Premium rates are set by FEMA. The WYO participating companies write the flood insurance coverage qualifying for the program on their own policies, perform their own underwriting, premium collections, claim payments, administration, and premium tax payments for policies written under the program.

Monthly accountings are made to FIA and participants are allowed to draw upon FEMA letters of credit for deficiencies of losses, loss expenses and administrative expenses in excess of premiums, subject to certain percentage limitations on expenses.

For purposes of statutory reporting in the WYO participating insurers' annual statements, balances due from or to FEMA should be treated as ceded reinsurance balances receivable or payable in Schedule F, FEMA should be identified as the reinsurer and assigned the NAIC Company Code 46990.

24. The Annual Statement Instructions require the following disclosures related to reinsurance:

11. Unsecured Reinsurance Recoverables

Instruction:

If the company has with any individual reinsurers, authorized or unauthorized, an unsecured aggregated recoverables losses, paid and unpaid including IBNR, loss adjustment expenses, and unearned premium that exceeds 3% of the company's policyholder surplus, list each individual reinsurer and the unsecured aggregated recoverable pertaining to that reinsurer. If the individual reinsurer is part of a group, list the individual reinsurers, each of its related group members having reinsurance with the reporting company, and the total unsecured aggregate recoverables for the entire group.
Include: The NAIC group code number, where appropriate, and the Federal Employer Identification Number for each individual company.

12. Reinsurance Recoverable in Dispute

Instruction:

Reinsurance recoverable on paid and unpaid (including IBNR) losses in dispute by reason of notification, arbitration or litigation shall be identified in the schedule if the amounts in dispute from any company (and/or affiliate) exceeds 5% of the ceding company’s policyholder’s surplus or if the aggregate of all disputed items exceeds 10% of the ceding company’s policyholder’s surplus. “Notification” means a formal written communication from a reinsurer denying the validity of the coverage.

Illustration:

<table>
<thead>
<tr>
<th>Name of Reinsurer</th>
<th>Total Amount in Dispute (Including IBNR)</th>
<th>Notification</th>
<th>Arbitration</th>
<th>Litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A - Reinsurer</td>
<td>$10,000</td>
<td></td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>B - Reinsurer</td>
<td>$20,000</td>
<td>$10,000</td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td>C - Reinsurer</td>
<td>$30,000</td>
<td></td>
<td>$30,000</td>
<td></td>
</tr>
</tbody>
</table>

13. Reinsurance Assumed and Ceded

a. Instruction:

Report the maximum amount of return commission which would have been due reinsurers if they or you had canceled all of your company’s reinsurance or if you or a receiver had canceled all of your company’s insurance assumed as of the end of the period covered by this annual statement with the return of the unearned premium reserve. Equity amounts should be computed by applying the fixed or provisional commission rate for each contract to the unearned premium reserve. Line (iii) of Column 5 plus Line (iv) must equal Page 3, Column 1, Line 9.

Illustration:

<table>
<thead>
<tr>
<th>ASSUMED REINSURANCE</th>
<th>CEDED REINSURANCE</th>
<th>NET</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Affiliates</td>
<td>$_____ $_____</td>
<td>$_____ $_____</td>
</tr>
<tr>
<td>ii. All Other</td>
<td>_____ _____</td>
<td>_____ _____</td>
</tr>
<tr>
<td>iii. TOTAL</td>
<td>$_____ $_____</td>
<td>$_____ $_____</td>
</tr>
<tr>
<td>iv. Direct Unearned Premium Reserve</td>
<td>$_____</td>
<td></td>
</tr>
</tbody>
</table>
b. **Instruction:**

Additional or return commission predicated on loss experience or on any other form of profit sharing arrangements in this annual statement as a result of existing contractual arrangements are accrued as follows:

**Illustration:**

<table>
<thead>
<tr>
<th>REINSURANCE</th>
<th>DIRECT</th>
<th>Assumed</th>
<th>Ceded</th>
<th>NET</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td></td>
</tr>
<tr>
<td>i. Contingent Commission</td>
<td>$_____</td>
<td>$_____</td>
<td>$_____</td>
<td>$_____</td>
</tr>
<tr>
<td>ii. Sliding Scale Adjustments</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>iii. Other Profit Commission Arrangements</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
<tr>
<td>iv. TOTAL</td>
<td>______</td>
<td>______</td>
<td>______</td>
<td>______</td>
</tr>
</tbody>
</table>

c. **Instruction:**

Disclose all contracts of reinsurance covering losses that have occurred prior to the inception of the contract that have not been accounted for in conformity with the instructions contained in the NAIC *Accounting Practices and Procedures* manual, Chapter 22.

**Illustration:**

All contracts of reinsurance covering losses that have occurred prior to the inception of the contract have been accounted for in conformity with the instructions contained in the NAIC *Accounting Policies and Procedures* manual, Chapter 22, except for the following:

15. **Uncollectible Reinsurance**

**Instruction:**

Describe uncollectible reinsurance written off during the year reported in the following annual statement classifications, including the names or names of the reinsurer(s):

1. Losses incurred;
2. Loss adjustment expenses incurred;
3. Premiums earned;
4. Other.

**Illustration:**

Uncollectible Reinsurance Balances Written Off Through Income and Expense

The Company has written off in the current year reinsurance balances due (from the companies listed below) in the amount of: $_______, which is reflected as:

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$_____</td>
</tr>
</tbody>
</table>
16. Commutation of Ceded Reinsurance

Instruction:
Describe the commutation of ceded reinsurance during the year reported in the following annual statement classifications, including the name or names of the reinsurer(s):

i. Losses incurred $________
ii. Loss adjustment expenses incurred $________
iii. Premiums earned $________
iv. Other $________

Illustration:

Commutation of Ceded Reinsurance

The Company has reported in its operations in the current year as a result of commutation of reinsurance with the companies listed below, amounts which are reflected as:

i. Losses incurred $________
ii. Loss adjustment expenses incurred $________
iii. Premiums earned $________
iv. Other $________

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ</td>
<td>$_____</td>
</tr>
<tr>
<td>ZYX</td>
<td>$_____</td>
</tr>
</tbody>
</table>

17. Retroactive Reinsurance

Instruction:

The following shall be completed for all retroactive reinsurance contracts that transfer liabilities for losses that have already occurred and that will generate special surplus transactions. Transactions utilizing “Deposit Accounting” shall not be reported in this note.

The insurer (assuming or ceding) shall assign a unique number to each retroactive reinsurance contract and shall utilize this number for as long as the contract exists. The summary (aggregate of all retroactive reinsurance contracts) is to be reported in the form below. For further guidance, refer to Chapter 22 of the NAIC *Accounting Policies and Procedures* manual. Analysis in a similar format on individual retroactive reinsurance contracts may be necessary upon request.
As:

A. Reserves Transferred:
   1. Initial Reserves $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Total $ __________ $ __________

B. Consideration Paid or Received
   1. Initial $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Total $ __________ $ __________

C. Amounts Recovered/Paid (cumulative)
   1. Prior Year(s) $ __________ $ __________
   2. Current Year ___________ ___________
   3. Total $ __________ $ __________

D. Special Surplus from Retroactive Insurance
   1. Initial $ __________ $ __________
   2. Adjustments - Prior Year(s) ___________ ___________
   3. Adjustments - Current Year ___________ ___________
   4. Closing Balance $ __________ $ __________

E. List the other insurers included in the above transactions

<table>
<thead>
<tr>
<th>Assumed Company</th>
<th>Amount</th>
<th>Ceded Company</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ _______</td>
<td>___________</td>
<td>$ _______</td>
</tr>
<tr>
<td></td>
<td>___________</td>
<td>___________</td>
<td>___________</td>
</tr>
<tr>
<td>Total</td>
<td>$ _______ *</td>
<td>Total</td>
<td>$ _______ *</td>
</tr>
</tbody>
</table>

* Total amounts must agree with totals in A.4.

25. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provide the following guidance for line 3 of Schedule F-Part 7, Provision for Overdue Reinsurance:

   Line 3 - Line 1 x Line 2
   If the company’s experience indicates that a higher amount should be provided, such higher amount should be entered

**Generally Accepted Accounting Principles**

26. As noted in paragraph 8, FAS 113 is generally consistent with Chapter 22. The paragraphs that follow are excerpts from FAS 113 which provide guidance on areas that differ from Chapter 22 (see paragraph 8 for a summary of differences).
27. FAS 113 eliminated the practice of insurance enterprises of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance:

Reporting Assets and Liabilities Related to Reinsurance Transactions

14. Reinsurance contracts that are legal replacements of one insurer by another (often referred to as assumption and novation) extinguish the ceding enterprise’s liability to the policyholder and result in removal of related assets and liabilities from the financial statements of the ceding enterprise. Reinsurance contracts in which a ceding enterprise is not relieved of the legal liability to its policyholder do not result in removal of the related assets and liabilities from the ceding enterprise’s financial statements. Ceding enterprises shall report estimated reinsurance receivables arising from those contracts separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid reinsurance premiums) also shall be reported separately as assets.

15. Amounts receivable and payable between the ceding enterprise and an individual reinsurer shall be offset only when a right of setoff exists, as defined in Interpretation 39.

16. The amounts of earned premiums ceded and recoveries recognized under reinsurance contracts either shall be reported in the statement of earnings, as separate line items or parenthetically, or those amounts shall be disclosed in the footnotes to the financial statements.

28. FAS 113 contains the following guidance on retroactive reinsurance agreements:

22. Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortized over the estimated remaining settlement period. If the amounts and timing of the reinsurance recoveries can be reasonably estimated, the deferred gain shall be amortized using the effective interest rate inherent in the amount paid to the reinsurer and the estimated timing and amounts of recoveries from the reinsurer (the interest method). Otherwise, the proportion of actual recoveries to total estimated recoveries (the recovery method) shall determine the amount of amortization.

23. If the amounts paid for retroactive reinsurance exceed the recorded liabilities relating to the underlying reinsured contracts, the ceding enterprise shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings.

24. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22, shall be adjusted or established as a result. When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment shall be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction.

6 Decreases in the estimated amount of the liabilities shall reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss shall not be deferred. The resulting difference shall be recognized in earnings immediately as described in paragraph 23.
29. EITF 93-6 contains the following guidance on multiple-year retrospectively rated reinsurance contracts:

**ISSUE**

An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as “funded catastrophe covers.” These contracts include a “retrospective rating” provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract’s future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.

The issues are (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), whether the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) how to account for changes in coverage based on past experience under the contract.

**EITF DISCUSSION**

The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises. With respect to condition (2) above, a Task Force member asked whether a contract could be split for purposes of evaluating risk transfer. An FASB staff representative responded that Statement 113 applies to “a contract” and that determining the substance of a contract is a judgmental matter. If an agreement with a reinsurer consists of both risk transfer and nonrisk transfer coverages that have been combined into a single legal document, those coverages must be considered separately for accounting purposes. The FASB staff representative noted that paragraphs 59 and 60 of Statement 113 indicate that the Board did not intend for different kinds of exposures combined in a program of reinsurance to be evaluated for risk transfer and accounted for together because that would allow contracts that do not meet the conditions for reinsurance accounting to be accounted for as reinsurance by being designated as part of a program that in total meets the conditions for reinsurance accounting.

For contracts that meet all of the conditions described above, the Task Force reached the following consensuses:

**Issue 1.** The ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset to the extent that the ceding enterprise has an obligation to pay cash (or other consideration) to the reinsurer that would not have been required absent experience under the contract. The amount recognized in the current period should be computed, using a with-and-
without method, as the difference between the ceding enterprise’s total contract costs before and after the experience under the contract as of the reporting date, including costs such as premium adjustments, settlement adjustments, and impairments of coverage. The amount of premium expense related to impairments of coverage should be measured in relation to the original contract terms. Future experience under the contract (that is, future losses and future premiums that would be paid regardless of past experience) should not be considered in measuring the amount to be recognized.

In applying the consensus reached in Issue 1, if the ceding enterprise could terminate the contract prior to the end of its term and if termination would change the amounts paid (for example, if terminating the contract would cost less than continuing the contract in force), the liability resulting from the contract should be measured as follows:

1. If a decision to terminate has been made, the measurement should be based on an assumption of termination and experience to date.

2. Otherwise, the measurement should be based on the lesser of the following:
   a. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date) or
   b. The total incremental cost that would be paid based on the with-and-without calculation assuming experience to date and assuming no termination (that is, excluding the effects of future losses and future premiums that would have been paid regardless of experience to date).

Issue 2. The ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability to the extent that any cash (or other consideration) would be payable from the assuming enterprise to the ceding enterprise based on experience to date under the contract.

Issue 3. The ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in other contract costs. For example, the effects of decreases in coverage without a commensurate reduction in premium should be recognized as a loss by the ceding enterprise and as a gain by the assuming enterprise when the event causing the decrease in coverage takes place.

The Task Force noted that deposit accounting cannot be used to avoid loss recognition that would otherwise be required (for example, the ceding enterprise has no future coverage relating to the deposit with the reinsurer and therefore the deposit is not recoverable).

The provisions of these consensuses are effective as of July 22, 1993 (for example, they are to be initially applied no later than the third quarter of 1993 for calendar-year enterprises) and are to be initially applied in one of two ways:

1. By recognition of the net effect of applying the provisions at the beginning of an enterprise’s current fiscal year as a cumulative effect of a change in accounting principle in accordance with paragraph 20 of Opinion 20. Under this approach, the disclosures required by paragraph 21 of Opinion 20 would be required as long as the income statement for the current fiscal year is presented. The Task Force noted that the provisions of Statement 3 apply to all interim periods presented.

2. By restatement of financial statements for all periods presented as long as that restatement is not prohibited by Statement 113.
The SEC Observer stated that in addition to the disclosures provided under Opinion 20, the SEC staff will require registrants to disclose the nature and the significance of the transactions giving rise to the change. The SEC Observer also noted that registrants would be required to make SAB 74 disclosures for the financial statements filed prior to the period in which this change is adopted.

The Task Force requested that the FASB staff views on Issue 93-6, distributed to the Task Force as Supplement No. 1 (Revised) to the Issue Summary and the FASB Viewpoints article, “Accounting for Reinsurance: Questions and Answers about Statement 113,” be included in Appendix D of EITF Abstracts. [Note: See Appendix D, Topics No. 34 and 35.]

STATUS

A related issue was discussed in Issue No. 93-14, “Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises.” That Issue considers how a multiple-year retrospectively rated contract arising from an insurance transaction that is not a reinsurance contract should be accounted for. The consensuses reached in Issue 93-14 were consistent with those reached in this Issue.

No further EITF discussion is planned.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts in Force
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65 - Property and Casualty Contracts
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance, Chapters 7, 8, and 22 (including Appendix A)
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies, Notes to Financial Statements and Schedule F
- Minutes of the December 3, 1995 meeting of the Property Casualty Reinsurance Study Group

Generally Accepted Accounting Principles
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FASB Statement No. 5, Accounting for Contingencies
- FASB Emerging Issues Task Force Issue No. 93-6, Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises-SEC Staff Accounting Bulletin No. 92, Accounting and Disclosures Relating to Loss Contingencies
- AICPA Statement of Position No. 92-5, Accounting for Foreign Property and Liability Reinsurance

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 76

Offsetting and Netting of Assets and Liabilities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not provide guidance on the reporting of assets and liabilities when a valid right of setoff exists (offsetting). As a result amounts are not consistently netted for statutory reporting. However, current statutory accounting does require that certain assets and liabilities be shown as a net amount for reporting purposes (netting) regardless of whether a valid right of setoff exists.

2. GAAP guidance on offsetting is provided in paragraph 7 of Accounting Principles Board Opinion No. 10, Omnibus Opinion - 1966 (APB 10) and FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts (FIN 39). This guidance allows offsetting only when a valid right of setoff exists and specified conditions are met or where netting is specifically permitted by other GAAP pronouncements. FIN 39 defines the conditions under which a valid right of setoff exists.

3. The purpose of this issue paper is to establish statutory accounting principles on offsetting assets and liabilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and to provide a reporting mechanism for the netting of assets and liabilities when required by this codification.

SUMMARY CONCLUSION

4. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 5 and 7. A right of setoff is a reporting entity’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the reporting entity. A valid right of setoff exists only when all the following conditions are met:

   a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement.
   
   b. The reporting party has the right to setoff the amount owed with the amount owed by the other party.
   
   c. The reporting party intends to setoff.
   
   d. The right of setoff is enforceable by law.

5. Assets and liabilities that meet the criteria for offset shall not be netted when prohibited by specific issue papers. An example of such is in the case of reinsurance recoverables on paid losses and ceded premiums payable as provided for in Issue Paper No. 75 - Property and Casualty Reinsurance (Issue Paper No. 75).

6. Amounts due to or from affiliates shall be offset and reported net only when the provisions of paragraph 4 above are met.
7. Netting of assets and liabilities for reporting purposes when no valid right of setoff exists shall be allowed only when provided for by specific issue papers. An example of such is in the case of real estate investments required to be shown net of encumbrances as provided for in Issue Paper No. 40 - Real Estate Investments (Issue Paper No. 40).

DISCUSSION

8. The conclusions above require offsetting when a valid right of setoff exists, unless prohibited in specific issue papers. This issue paper adopts paragraphs 1, 7, and 13 of APB 10 and FIN 39 with a modification to prohibit offsetting as provided in specific issue papers and require netting when provided in specific issue papers. GAAP uses the same criteria to permit offsetting as described in paragraph 4 of this issue paper and also permits netting where existing GAAP literature specifically prescribes it. Because this modification exists, there will be circumstances where items are offset under GAAP but not under statutory accounting principles.

9. Likewise, there are instances as provided for in specific issue papers where balances which do not meet the criteria in paragraph 4 are shown net for statutory reporting purposes where existing GAAP literature would not allow the amounts to be reflected as a single net balance. This difference is reflective of the varying objectives of regulation.

10. FASB Interpretation No. 41, Offseting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements (FIN 41) is a further interpretation of paragraph 7 of APB 10 and FIN 39. The guidance adopted in Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (Issue Paper No. 45) is consistent with FIN 41. However, Issue Paper No. 45 did not adopt FIN 41 because offsetting was not addressed in its entirety in the paper. The adoption of paragraph 7 of APB 10 and FIN 39 make it appropriate to adopt FIN 41 in this issue paper. This issue paper also adopts FASB Emerging Issues Task Force No. 86-25, Offseting Foreign Currency Swaps.

11. The statutory principles outlined in the conclusion above are consistent with the consistency concept in the Statement of Concepts. A pertinent excerpt follows:

   Consistency
   
   The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

12. The conclusions reached in this issue paper are consistent with the definition of liabilities in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) which defines a liability as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transaction(s) or event(s) and the definition of assets in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) which defines an asset as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Assets and liabilities exist independent of each other unless the requirements of paragraph 4 of this issue paper are met.

Drafting Notes/Comments

- Issue Paper No. 2 - Definition of Cash requires netting cash accounts with positive and negative balances.
- Issue Paper No. 40 - Real Estate Investments requires encumbrances on real estate investments to be netted against the investment.
Offsetting and Netting of Assets and Liabilities

- Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable and requires due premiums from policyholders to be netted with premiums due the reinsurer.
- Issue Paper No. 75 - Property and Casualty Reinsurance prohibits offsetting of reinsurance recoverables on paid losses with ceded premiums payable.
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements addresses FIN 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

13. The Property and Casualty Accounting Practices and Procedures Manual (P&C Accounting Practices and Procedures Manual), Chapter 22, Reinsurance, provides the following guidance:

**Accounting for Prospective Reinsurance Contracts:**

Amounts paid for prospective reinsurance that meet the conditions for reinsurance accounting shall be reported as a reduction of written and earned premiums by the ceding company and shall be earned over the remaining contract period in proportion to the amount of reinsurance protection provided. If the amounts paid are subject to adjustment and can be reasonably estimated, the basis for amortization shall be the estimated ultimate amount to be paid.

Changes in amounts of estimated recoverables shall be recognized as a reduction of gross losses and loss expenses incurred in the current period's statement of income. Reinsurance recoverables on paid losses shall be reported as an asset, “reinsurance recoverables on loss and loss adjustment expense payments”, in the balance sheet. Reinsurance recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses.

**Accounting for Retroactive Reinsurance Contracts:**

Certain reinsurance contracts which transfer both components of insurance risk cover liabilities which occurred prior to the effective date of the contract. Due to potential abuses involving the creation of surplus to policyholders, and the distortion of underwriting results, a special accounting treatment for such agreements is warranted.

Effective for accounting periods commencing on or after January 1, 1995, all retroactive reinsurance contracts entered into, renewed or amended on or after January 1, 1994 (including subsequent development of such transactions) must be fully disclosed in the NAIC annual and interim financial statements required to be filed and shall be accounted for in the following manner:

1. The ceding company must record, without recognition of the retroactive reinsurance, its loss and loss expense reserves on a gross basis on its balance sheet and in all schedules and exhibits.
2. The assuming company must exclude the retroactive reinsurance from its loss and loss expense reserves and from its schedules and exhibits.
3. The ceding company and the assuming company must report by write-in item on Page 3, the total amount of all retroactive reinsurance, identified as "retroactive reserve ceded or assumed" recorded as a contra-liability by the ceding company and as a liability by the assuming company.

14. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:
Book Value

In general, book value refers to amounts at which individual items are stated in books of account of in financial statements. For real estate that is occupied by the company, and for investment in real estate, this would be cost or other basic value, stated net of any encumbrances, plus additions and increases by adjustments, less retirements and decreases by adjustments, including depreciation. Encumbrances include mortgages and other related debt, and may also include accrued costs of acquisition or construction.

Statement Value

Real estate shall be shown net of any encumbrance. The instructions for the annual statement require that the admitted value of properties occupied by the company (home office real estate) shall not exceed actual costs, plus capitalized improvement, less normal depreciation. This formula is to apply whether the property is held directly or indirectly by the company.

Similar guidance is provided in The Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4, Real Estate.

Generally Accepted Accounting Principles

15. Paragraph 7 of APB 10 provides the following guidance:

1. It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists. Accordingly, the offset of cash or other assets against the tax liability or other amounts owing to governmental bodies is not acceptable except in the circumstances described in paragraph 3 below.

2. Most securities now issued by governments are not by their terms designed specifically for the payment of taxes and, accordingly, should not be deducted from taxes payable on the balance sheet.

3. The only exception to this general principle occurs when it is clear that a purchase of securities (acceptable for the payment of taxes) is in substance an advance payment of taxes that will be payable in the relatively near future, so that in the special circumstances the purchase is tantamount to the prepayment of taxes. This occurs at times, for example, as an accommodation to a local government and in some instances when governments issue securities that are specifically designated as being acceptable for the payment of taxes of those governments.

16. FIN 39 provides the following guidance:

INTERPRETATION

General Principle

5. Opinion 10, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. A right of setoff exists when all of the following conditions are met:

a. Each of two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.
A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

Special Applications

7. Various accounting pronouncements specify accounting treatments in circumstances that result in offsetting or in a presentation in a statement of financial position that is similar to the effect of offsetting. This Interpretation does not modify the accounting treatment in the particular circumstances prescribed by any of the following pronouncements:

- FASB Statements and Interpretations
- APB Opinions
- Accounting Research Bulletins
- FASB Technical Bulletins
- AICPA Accounting Interpretations
- AICPA Audit and Accounting Guides
- AICPA Industry Audit Guides
- AICPA Statements of Position

Examples of those pronouncements are:
- FASB Statement No. 13, Accounting for Leases (leveraged leases, paragraphs 42-47)
- FASB Statement No. 87, Employers’ Accounting for Pensions (accounting for pension plan assets and liabilities)
- FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions (accounting for plan assets and liabilities)
- FASB Statement No. 109, Accounting for Income Taxes (net tax asset or liability amounts reported)
- APB Opinion No. 30, Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions (reporting of discontinued operations)
- AICPA Audit and Accounting Guides, Audits of Brokers and Dealers in Securities (trade date accounting for trading portfolio positions), and Construction Contractors and Audits of Federal Government Contractors (advances received on construction contracts)
- AICPA Industry Audit Guide, Audits of Banks (reciprocal balances with other banks)

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 22
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- Issue Paper No. 2 - Definition of Cash
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 40 - Real Estate Investments
- Issue Paper No. 75 - Property and Casualty Reinsurance
- Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.

**Generally Accepted Accounting Principles**
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
- FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*
- FASB Emerging Issues Task Force No. 86-25, *Offsetting Foreign Currency Swaps*

**State Regulations**
No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 77

Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. GAAP guidance for the disclosure of accounting policies is contained in Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies (APB 22). This guidance requires the identification and description of accounting principles followed by a company and the methods of applying those principles that materially affect the determination of financial position or results of operations. Current statutory guidance requires a general disclosure that the financial statements have been prepared in accordance with the Annual Statement Instructions and Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) except to the extent state laws differ. The impact of such deviations is required to be disclosed if material. The disclosure of certain accounting policies within specific notes to the Annual Statement is required by the Annual Statement Instructions.

2. GAAP guidance for the disclosure of permitted accounting practices is contained in AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises (SOP 94-5). This guidance requires the disclosure of those permitted statutory accounting practices that have a material impact on statutory surplus or risk based capital or when prescribed statutory accounting practices do not address the accounting for the transaction. Current statutory guidance is contained in the Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Annual Statement Instructions), Notes to the Financial Statements. This guidance requires the disclosure of any accounting practices not in conformity with the Annual Statement Instructions and the Accounting Practices and Procedures Manuals.

3. GAAP guidance for the disclosure of risk and uncertainties is contained in AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties (SOP 94-6). This guidance requires the disclosure about risks and uncertainties in four areas at the date of the financial statements: nature of operations, use of estimates in the preparation of financial statements, certain significant estimates, and current vulnerability due to certain concentrations. Current statutory guidance requires certain specific disclosures of risks and uncertainties, however, the requirements are not as broad as those of SOP 94-6.

4. The purpose of this issue paper is to establish statutory accounting principles for the disclosure of accounting policies, risks and uncertainties, and other disclosures that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. Except as noted in paragraph 8, the disclosure requirements of paragraphs 6 through 21 of this issue paper do not apply to quarterly financial statements. To the extent that disclosures required by this or any other issue paper are made within specific notes, schedules or exhibits to the financial statements, those disclosures are not required to be duplicated in a separate note. Annual statutory financial
statements which are not accompanied by Annual Statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by this statement.

**Accounting Policies**

6. For the purposes of this issue paper, accounting policies are defined as the specific accounting principles and the methods of applying those principles that are utilized in preparing the statutory financial statements.

7. Disclosure shall be made of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations of the reporting company. The disclosure should encompass important judgments as to the appropriateness of principles relating to recognition of revenue particularly when selecting between acceptable alternatives, or methods particular to the business.

8. Disclosure of accounting policies generally should be made in a separate *Summary of Significant Accounting Policies* preceding the notes to the financial statements or as the initial note. If the reporting entity has changed the accounting policies since the end of its preceding year, the changes shall be disclosed in the quarterly financial statements.

9. NAIC statutory accounting practices and procedures are those that are set forth in the Accounting Practices and Procedures Manual. If a reporting entity employs accounting practices that depart from NAIC accounting practices and procedures, disclosure of the following information about those accounting practices that affect statutory surplus or risk-based capital shall be made:


   b. A statement that the accounting practice differs from NAIC statutory accounting practices and procedures.

   c. The monetary effect on statutory surplus of using an accounting practice which differs from NAIC statutory accounting practices and procedures.

10. Disclosure of the following information shall be made about accounting practices when NAIC statutory accounting practices and procedures do not address the accounting for the transaction:

    a. A description of the transaction and of the accounting practice used.

    b. A statement that NAIC statutory accounting practices and procedures do not address the accounting for the transaction.

**Risks and Uncertainties**

11. Companies shall make disclosures in their financial statements about risks and uncertainties existing as of the date of those statements in the following areas:

    a. Nature of operations

    b. Use of estimates in the preparation of financial statements

    c. Certain significant estimates

    d. Current vulnerability due to certain concentrations

12. *Nature of Operations*: Financial statements should include a description of the ownership and relationships of the reporting entity and all affiliated companies, and a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative
importance of its operations in each business and the basis for the determination (e.g., assets, revenues, or earnings). Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major.

13. **Use of Estimates in the Preparation of Financial Statements**: Financial statements shall include an explanation that the preparation of financial statements in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Manuals requires the use of management’s estimates.

14. **Certain Significant Estimates**: Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

   a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

   b. The effect of the change would be material to the financial statements.

The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term (generally, a period of time not to exceed one year from the date of the financial statements). If the estimate involves a loss contingency as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies, and Impairments of Assets (Issue Paper No. 5), the disclosure shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Reporting entities should disclose the factors that cause the estimate to be sensitive to change.

15. **Current Vulnerability Due to Certain Concentrations**: Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks manifest themselves differently, depending on the nature of the concentration, and vary in significance.

16. Financial statements shall disclose the concentrations described in paragraph 17 of this issue paper if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

   a. The concentration exists at the date of the financial statements.

   b. The concentration makes the enterprise vulnerable to the risk of a near-term severe (more than material but less than catastrophic) impact.

   c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

17. Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph 16 of this issue paper. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

   a. **Concentrations in the volume of business transacted with a particular customer, supplier, or lender**. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For the purposes of this issue paper, it is always considered at least reasonably possible that any customer will be lost in the near term.
b. **Concentrations in revenue from particular products or services.** The potential for severe impact can result, for example, from volume or price changes for a particular source of revenue.

c. Concentrations in the available sources of materials, labor, services, licenses, or other rights used in the entity’s operations. The potential for severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. **Concentrations in the market or geographic area in which an entity conducts its operations.** The potential for severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For the purposes of this issue paper, it is always considered at least reasonably possible that operations located outside an entity’s home country will be disrupted in the near term.

**Other Disclosures**

18. Separate issue papers have disclosure requirements specific to the topics addressed in those issue papers. Additional disclosure requirements not addressed in other issue papers are included herein.

19. For each year that a balance sheet is presented, reporting entities shall disclose the following information in the notes to the financial statements:

a. Amounts not recorded in the financial statements that represent segregated funds held for others, the nature of the assets and the related fiduciary responsibilities associated with such assets. One example of such an item is escrow accounts held by title insurance companies.

b. The amount and nature of any assets pledged to others as collateral.

20. The financial statements shall disclose forward commitments which are not derivative instruments (e.g., the commitment to purchase a GNMA security two months after the commitment date, or a private placement six months after the commitment date).

**Supplemental Investment Disclosure**

21. For the current year, reporting entities shall disclose the information required by Appendix A-001, Investments of Insurers. A Summary Investment Schedule and Investment Risk Interrogatories shall be filed with the audited statutory financial statements. The Summary Investment Schedule shall be filed with the Annual Statement whereas the interrogatories shall be filed as a supplement to the Annual Statement by April 1 for the applicable reporting period.

**DISCUSSION**

22. This issue paper adopts APB 22, Accounting Research Bulletin No. 43, Chapter 2A, *Form of Statements – Comparative Financial Statements*, SOP 94-5 and SOP 94-6. The disclosures related to loss reserves adopted in Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55), are consistent with the guidance in SOP 94-5. However, Issue Paper No. 55 did not adopt SOP 94-5 because it was to be addressed in its entirety in this issue paper.
23. The statutory principles outlined in the conclusion above expand current statutory guidance relative to accounting policies, risks and uncertainties and other disclosures as follows:

   a. Paragraph 7 of this issue paper requires disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations in all statutory financial statements. Current statutory guidance requires disclosure of certain accounting policies in the notes to the Annual Statement as well as disclosure of all accounting policies that affect the assets, liabilities, capital and surplus or results of operations but only to the extent those financial statements are audited.

   b. Paragraph 11 requires the disclosure of certain risks and uncertainties existing at the date of the financial statements. Current statutory guidance requires this disclosure in statutory financial statements to the extent those financial statements are audited. This issue paper expands that requirement to include annual statement filings.

These changes were made to enhance the usefulness of financial statements to regulators and other users.

24. The statutory principles outlined in paragraphs 9 and 10 in the conclusion above expand current statutory guidance by requiring disclosure of accounting practices that depart from NAIC accounting practices and procedures and that have an effect on risk based capital or statutory surplus. This change was made because risk based capital is viewed as a primary indicator of a reporting entity’s solvency.

25. The disclosure requirements of this issue paper are consistent with the Statement of Concepts which states “... management must supplement the financial statements with sufficient disclosures (e.g., notes to financial statements, management discussion and analysis, and supplementary schedules and exhibits) to assist financial statement users in evaluating the information provided.”

26. The conclusions reached in this issue paper are consistent with GAAP except to the extent they are not required to be made in interim statutory financial statements. GAAP requires these disclosures in all financial statements regardless of the period.

27. The information required by this issue paper provides disclosure in those circumstances where the accompanying exhibits and schedules are not part of the company’s financial statements (e.g., annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments
- The disclosure requirements of this issue paper relative to risks and uncertainties are separate from and do not change in any way the requirements or criteria of Issue Paper No. 5.
- Disclosures relating to environmental liabilities are addressed in Issue Paper No. 65 - Property Casualty Contracts.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
28. The Annual Statement Instructions for both Property and Casualty and Life, Accident and Health Insurance Companies (Notes to the Financial Statements) provide the following guidance:

   1. Basis of Presentation

      Instruction:

      Indicate that the statement has been completed in accordance with the NAIC Annual Statement Instructions and Accounting Practices and Procedures manuals except to the extent that state law differs. Note any deviations from the rules to the extent this deviation impacts the financial information contained in the annual statement.
Illustration:

The accompanying financial statements of the Company have been prepared in conformity with the Annual Statement Instructions and Accounting Practices and Procedures Annual Statement Instructions except for the following item(s) which resulted in surplus being increased (decreased) by $__________. The deviation(s) are as follows:

**Generally Accepted Accounting Principles**

29. APB 22 provides the following guidance (note all references to statement of changes in financial position have been amended to statement of cash flows by FASB Statement No. 95, *Statement of Cash Flows*):

**DISCUSSION**

5. Financial statements are the end product of the financial accounting process, which is governed by generally accepted accounting principles on three levels: pervasive principles, broad operating principles, and detailed principles. Applying generally accepted accounting principles requires that judgment be exercised as to the relative appropriateness of acceptable alternative principles and methods of application in specific circumstances of diverse and complex economic activities. Although the combined efforts of professional accounting bodies, of business, and of the regulatory agencies have significantly reduced the number of acceptable alternatives and are expected to reduce the number further, judgment must nevertheless be exercised in applying principles at all three levels.

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6. The accounting policies of a reporting entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles and that, accordingly, have been adopted for preparing the financial statements.

7. The accounting policies adopted by a reporting entity can affect significantly the presentation of its financial position, cash flows, and results of operations. Accordingly, the usefulness of financial statements for purposes of making economic decisions about the reporting entity depends significantly upon the user’s understanding of the accounting policies followed by the entity.

**OPINION**

Applicability

8. The Board concludes that information about the accounting policies adopted by a reporting entity is essential for financial statement users. When financial statements are issued purporting to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles, a description of all significant accounting policies of the reporting entity should be included as an integral part of the financial statements. In circumstances where it may be appropriate to issue one or more of the basic financial statements without the others, purporting to present fairly the information given in accordance with generally accepted accounting principles, statements so presented should also include disclosure of the pertinent accounting policies.
9. The Board also concludes that information about the accounting policies adopted and followed by not-for-profit entities should be presented as an integral part of their financial statements.

10. The provisions of paragraphs 8 and 9 above are not intended to apply to unaudited financial statements issued as of a date between annual reporting dates (e.g., each quarter) if the reporting entity has not changed its accounting policies since the end of its preceding fiscal year.

2 The Board recognizes also that it may be appropriate to omit disclosure in some other circumstances for example, from financial statements restricted to internal use only (see Statement on Auditing Procedures No. 38, paragraphs 5 and 6) and from certain special reports in which incomplete or no financial presentations are made (see Statement on Auditing Procedures No. 33, Chapter 13, paragraphs 9 and 10).

11. This Opinion does not supersede any prior pronouncement of the American Institute of Certified Public Accountants relating to disclosure requirements.

Content

12. Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

   a. A selection from existing acceptable alternatives;

   b. Principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry;

   c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

13. Examples of disclosures by a business entity commonly required with respect to accounting policies would include, among others, those relating to basis of consolidation, depreciation methods, amortization of intangibles, inventory pricing, accounting for research and development costs (including basis for amortization), translation of foreign currencies, recognition of profit on long-term construction-type contracts, and recognition of revenue from franchising and leasing operations. This list of examples is not all-inclusive.

14. Financial statement disclosure of accounting policies should not duplicate details (e.g., composition of inventories or of plant assets) presented elsewhere as part of the financial statements. In some cases, the disclosure of accounting policies should refer to related details presented elsewhere as part of the financial statements; for example, changes in accounting policies during the period should be described with cross-reference to the disclosure required by APB Opinion No. 20, Accounting Changes, of the current effect of the change and of the pro forma effect of retroactive application.

Format

15. The Board recognizes the need for flexibility in matters of format (including the location) of disclosure of accounting policies provided that the reporting entity identifies and describes its significant accounting policies as an integral part of its financial statements in accordance with
the foregoing guides in this Opinion. The Board believes that the disclosure is particularly useful if
given in a separate Summary of Significant Accounting Policies preceding the notes to financial
statements or as the initial note. Accordingly, it expresses its preference for that format under the
same or a similar title.

30. SOP 94-6 provides the following guidance:

Introduction
.01 The volatile business and economic environment underscores a need for improved disclosure
about the significant risks and uncertainties that face reporting entities. In 1987, the AICPA
issued the Report of the Task Force on Risks and Uncertainties (the Report), which was intended
to help standards setting bodies and others identify practical methods of improving the
information communicated to users of financial statements to help them assess those risks and
uncertainties. This Statement of Position (SOP) is largely based on the Report. The central
feature of this SOP’s disclosure requirements is selectivity: specified criteria serve to screen the
host of risks and uncertainties that affect every entity so that required disclosures are limited to
matters significant to a particular entity.

.02 The disclosures focus primarily on risks and uncertainties that could significantly affect the
amounts reported in the financial statements in the near term or the near-term functioning of the
reporting entity. The risks and uncertainties this SOP deals with can stem from the nature of the
entity’s operations, from the necessary use of estimates in the preparation of the entity’s financial
statements, and from significant concentrations in certain aspects of the entity’s operations.

Scope
.03 This SOP applies to financial statements prepared in conformity with generally accepted
accounting principles (GAAP) applicable to nongovernmental entities. It applies to all entities that
issue such statements. While this SOP applies to complete interim financial statements, it does
not apply to condensed or summarized interim financial statements. If comparative financial
statements are presented, the disclosure requirements apply only to the financial statements for
the most recent fiscal period presented.

1 However, see Accounting Principles Board (APB) Opinion No. 28, Interim Financial Reporting, paragraph 30,
for guidance on disclosure of contingencies in summarized interim financial information of publicly traded
companies.

.04 The disclosure requirements do not encompass risks and uncertainties that might be
associated with management or key personnel, proposed changes in government regulations;
proposed changes in accounting principles, or deficiencies in the internal control structure. Nor
do they encompass the possible effects of acts of God, war, or sudden catastrophes.

Relationship to Other Pronouncements
.05 The disclosure requirements of this SOP in many circumstances are similar to or overlap the
disclosure requirements in certain pronouncements of the Financial Accounting Standards Board
(FASB), such as FASB Statement of Financial Accounting Standards No. 5, Accounting for
Contingencies, and, for public business enterprises, FASB Statement No. 14, Financial Reporting
for Segments of a Business Enterprise. The disclosure requirements of this SOP in many
circumstances also are similar to or overlap the disclosure requirements in certain
pronouncements of the Securities and Exchange Commission (SEC). This SOP does not alter
the requirements of any FASB or SEC pronouncement.

.06 Certain disclosure requirements in this SOP supplement the requirements of other
authoritative pronouncements. In many cases, however, the disclosure requirements in this SOP,
particularly those relating to certain significant estimates, will be met or partly met by compliance
with such other pronouncements.
Definitions
.07 This SOP uses the following terms with the definitions indicated:

Near term. A period of time not to exceed one year from the date of the financial statements.

Severe impact. (Used in reference to current vulnerability due to certain concentrations. See paragraph .21.) A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user’s decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity. Some events are material to an investor because they might affect the price of an entity’s capital stock or its debt securities, but they would not necessarily have a severe impact on (disrupt) the enterprise itself. The concept of severe impact, however, includes matters that are less than catastrophic.

Conclusions
.08 The Accounting Standards Executive Committee (AcSEC) of the AICPA has concluded that reporting entities should make disclosures in their financial statements beyond those now required or generally made in financial statements about the risks and uncertainties existing as of the date of those statements in the following areas:

   a. Nature of operations
   b. Use of estimates in the preparation of financial statements
   c. Certain significant estimates
   d. Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by this SOP may be combined in various ways, grouped together, or placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the requirements of other authoritative pronouncements.

.09 The following detailed discussion of the four areas of disclosure enumerated in paragraph .08 should be read in conjunction with the “Illustrative Disclosures” in appendix A [paragraph .27] of this SOP, which provide guidance for implementing them.

Nature of Operations
.10 Financial statements should include a description of the major products or services the reporting entity sells or provides and its principal markets including the locations of those markets. If the entity operates in more than one business, the disclosure should also indicate the relative importance of its operations in each business and the basis for the determination for
example assets, revenues, or earnings. Not-for-profit organizations’ disclosures should briefly describe the principal services performed by the entity and the revenue sources for the entity’s services. Disclosures about the nature of operations need not be quantified; relative importance could be conveyed by use of terms such as predominately, about equally, or major and other.\(^5\)

**Use of Estimates in the Preparation of Financial Statements**

.11 Financial statements should include an explanation that the preparation of financial statements in conformity with GAAP requires the use of management’s estimates.

**Certain Significant Estimates**

.12 Various accounting pronouncements require disclosures about uncertainties addressed by those pronouncements. In particular, paragraphs 9 through 12, and 17b, and footnote 6 of FASB Statement No. 5 specify disclosures to be made about contingencies \(^6\) that exist at the date of the financial statements. The disclosure requirements of paragraphs 9 through 12 of Statement No. 5 are further clarified in FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss. In addition to disclosures required by FASB Statement No. 5 and other accounting pronouncements, this SOP requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below

\(^5\) See paragraph B-17 in appendix B [paragraph .28] for a comparison of this SOP’s disclosure requirements concerning nature of operations with the disclosure requirements for public companies in FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise.

\(^6\) FASB Statement No. 5 defines a contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (hereinafter a ‘gain contingency’) or loss (hereinafter a ‘loss contingency’) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.”

.13 Disclosure regarding an estimate should be made when known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

a. It is at least reasonably possible\(^7\) that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.

\(^7\) The term reasonably possible is used in this SOP consistent with its use in FASB Statement No. 5 to mean that the chance of a future transaction or event occurring is more than remote but less than likely.

b. The effect of the change would be material to the financial statements.

.14 The disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible\(^8\) that a change in the estimate will occur in the near term.\(^9\) If the estimate involves a loss contingency covered by FASB Statement No. 5, the disclosure also should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required.
Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

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8 The words reasonably possible need not be used in the disclosures required by this SOP

9 FASB Statement No. 5 states in paragraph 17b that “adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization”

.15 Many entities use risk-reduction techniques to mitigate losses or the uncertainty that may result from future events. If the entity determines that the criteria in paragraph .13 are not met as a result of risk-reduction techniques, the disclosures described in paragraph .14 and disclosure of the risk reduction techniques are encouraged but not required.

.16 This SOP's disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5; rather, the disclosures required under this SOP supplement the disclosures required under Statement No. 5 as follows:

- If an estimate (including estimates that involve contingencies covered by FASB Statement No. 5) meets the criteria for disclosure under paragraph .13 of this SOP, this SOP requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; FASB Statement No. 5 does not distinguish between near-term and long-term contingencies.
- An estimate that does not involve a contingency covered by Statement No. 5, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph .13. This SOP requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

.17 Whether an estimate meets the criteria for disclosure under this SOP does not depend on the amount that has been reported in the financial statements, but rather on the materiality of the effect that using a different estimate would have had on the financial statements. Simply because an estimate resulted in the recognition of a small financial statement amount, or no amount, does not mean that disclosure is not required under this SOP.

.18 The following are examples of assets and liabilities and related revenues and expenses, and disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term:

- Inventory subject to rapid technological obsolescence
- Specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Capitalized motion picture film production costs
- Capitalized computer software costs
- Deferred policy acquisition costs of insurance enterprises
- Valuation allowances for commercial real estate loans
- Environmental remediation-related obligations
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- Amounts reported for long-term contracts

The above list is not intended to be all-inclusive.
The following are examples of events or changes in circumstances that indicate that an estimate associated with the carrying amount of a long-lived asset may be particularly sensitive to change in the near term:\footnote{On November 29, 1993, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, Accounting for the Impairment of Long-Lived Assets. This list was derived from the list in the FASB exposure draft of examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of a long-lived asset should be assessed for impairment. Any final Statement may contain additional or revised examples.}

a. A significant decrease in the market value of an asset
b. A significant change in the extent or manner in which an asset is used
c. A significant adverse change in legal factors or in the business climate that affects the value of an asset
d. An accumulation of costs significantly in excess of the amount originally expected to acquire or construct an asset
e. A history of losses associated with an asset, a projection or forecast (if either is available) that demonstrates continuing losses associated with an asset, or both

Current Vulnerability Due to Certain Concentrations

Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. Such risks of loss manifest themselves differently, depending on the nature of the concentration, and vary in significance.

Financial statements should disclose the concentrations described in paragraph .22 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.
b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

Concentrations, including known group concentrations, described below require disclosure if they meet the criteria of paragraph .21. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one category.

a. Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this SOP, it is always considered at least reasonably possible that any customer, grantor, or contributor will be lost in the near term.
b. Concentrations in revenue from particular products, services, or fund-raising events. The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
c. Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity’s operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area in which an entity conducts its operations. The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of this SOP, it is always considered at least reasonably possible that operations located outside an entity’s home country will be disrupted in the near term.

11 FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise, paragraph 34, provides guidance on determining foreign geographic areas.

.24 Disclosure of concentrations meeting the criteria of paragraph .21 should include information that is adequate to inform users of the general nature of the risk associated with the concentration. For those concentrations of labor (paragraph .22c) subject to collective bargaining agreements and concentrations of operations located outside of the entity’s home country (paragraph .22d) that meet the criteria of paragraph .21, the following specific disclosures are required:

- For labor subject to collective bargaining agreements, disclosure should include both the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- For operations located outside the entity’s home country, disclosure should include the carrying amounts of net assets and the geographic areas in which they are located.

Adequate information about some concentrations may already be presented in diverse parts of the financial statements. For example, adequate information about assets or operations located outside the entity’s home country may be included in disclosures made to comply with FASB Statement No. 14. In accordance with paragraph .08 of this SOP, such information need not be repeated.

Application of Disclosure Criteria

.25 An assessment of whether a disclosure is required should not be found to be in error simply as a result of future events; For example, reporting a concentration not followed by a severe impact does not imply that the disclosure should not have been made, because something that has only a reasonably possible chance of occurring obviously might not occur. Similarly, the occurrence of a severe impact related to a concentration not disclosed in the prior-year financial statements would not suggest noncompliance with this SOP’s requirements if an appropriate judgment had been made that a near term severe impact was not at least reasonably possible at the prior reporting date. In addition, a severe impact may arise from a concentration of which management did not have knowledge at the time the financial statements were issued.

31. SOP 94-5 provides the following guidance:

Introduction

.01 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.
.02 This 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 Appropriateness 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 criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements
.03 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 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 Statement of Position 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
.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures" [paragraph .13], and appendix B, "Discussion of Conclusions" [paragraph .14], of this SOP.

Permitted Statutory Accounting Practices
.05 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.

.06 Prescribed precodification statutory accounting practices include state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state,
.07 Permitted statutory accounting practices include practices not described in paragraph .06 but allowed by the domiciliary state insurance department. Insurance enterprises may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the enterprise wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction.

.08 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. 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:

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

APPENDIX A

Illustrative Disclosures
A-l. 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 SOP.

Permitted Statutory Accounting Practices
A-2. The following is an illustration of disclosures that an insurance enterprise would make before the codification is complete, to meet the requirements of paragraph .08 of this SOP.

Note X. Permitted Statutory Accounting Practices
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.

RELEVANT LITERATURE

Statutory Accounting
- NAIC Annual Statement Instructions
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies
- Accounting Research Bulletin No. 43, Chapter 2A, Form of Statements – Comparative Financial Statements
- AICPA Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties
- AICPA Statement of Position No. 94-5, Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 78

Employee Stock Ownership Plans

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the plan sponsors’ accounting for Employee Stock Ownership Plans (ESOPs) is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt obligations of ESOPs must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities.

2. GAAP addresses the plan sponsors’ accounting for ESOPs in AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans (SOP 93-6) and FASB Emerging Issues Task Force Issue No. 89-11, Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan (EITF 89-11).

3. The purpose of this issue paper is to establish statutory accounting principles for the plan sponsors’ accounting for ESOPs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It does not address financial reporting by ESOPs.

SUMMARY CONCLUSION

4. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 as a stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. For such plans, reporting entities shall adopt SOP 93-6 except that debt obligations of ESOPs shall be reported consistent with Issue Paper No. 80 - Debt (Issue Paper No. 80) and the related income tax effects shall be accounted for consistent with Issue Paper No. 83 - Accounting for Income Taxes (Issue Paper No. 83), as further clarified in this issue paper. There are two basic forms of ESOPs: nonleveraged and leveraged. A summary of the financial reporting for each is provided below.

Leveraged ESOPs

5. A leveraged ESOP borrows money to acquire shares of the employer company (sponsor). The money may be borrowed from the plan sponsor or from an outside lender, with or without a guarantee from the plan sponsor. The debt usually is collateralized by the employer’s shares. As required by Issue Paper No. 80, debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company, or the sale or exchange of the company’s securities.
6. The sponsor shall report the issuance of shares or the sale of treasury shares to an ESOP when they occur. The consideration recorded for the stock issued is unearned compensation and the unearned ESOP shares shall be reported as a separate reduction of surplus as a component of unassigned funds.

7. The unearned shares initially held by the ESOP in a suspense account are called suspense or unallocated shares. As the debt is repaid (generally from employer contributions and dividends on the employer’s stock) suspense shares are released and must be allocated to individual accounts as of the end of the ESOP’s fiscal year. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged as outlined in paragraph 26 of this issue paper.

8. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes (although such dividends are generally subject to normal dividend requirements under state statutes or regulations). Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost. Dividends on allocated shares should be charged to unallocated surplus.

9. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer shall report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, such difference shall be reported as a capital gain or loss on extinguishment of debt as defined in Issue Paper No. 80 and, accordingly, shall be charged to operations and disclosed in the notes to the financial statements in accordance with Issue Paper No. 24 - Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

10. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction as outlined in paragraph 26 of this issue paper.

Nonleveraged ESOPs

11. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan as outlined in paragraph 26 of this issue paper.

12. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to unallocated surplus, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Pension Reversion ESOPs

13. Pension reversion ESOPs are created by transferring the assets of a defined benefit pension plan to an existing or newly created ESOP and may be leveraged or nonleveraged. Pension reversion ESOPs should be accounted for as outlined in paragraph 26 of this issue paper.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

14. The amount of ESOP-related expense for a leveraged ESOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Such differences should be reported in accordance with Issue Paper No. 83.

15. If the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to unassigned funds. Conversely, if the cost of shares committed to be released is less than their fair value,
the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to unassigned funds to the extent of previous credits to unassigned funds related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

16. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations.

**Nonleveraged ESOPs**

17. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference that shall be accounted for in accordance with Issue Paper No. 83.

**Other**

18. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Securities subject to such repurchase obligations shall be reported as outstanding and as a component of surplus. The repurchase obligation shall be disclosed in accordance with paragraph 19 below.

**Disclosures**

19. An employer sponsoring an ESOP shall disclose the following information about the plan, if applicable.

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used;

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation and the classification of dividends on ESOP shares;

c. The amount of compensation cost recognized during the period;

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance sheet date;

e. The fair value of unearned ESOP shares at the balance sheet date;

f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

**DISCUSSION**

20. The Life/A&H Accounting Practices and Procedures Manual and the P & C Accounting Practices and Procedures Manual provide that debt obligations of Employee Stock Ownership Plans (ESOPs) must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. This issue paper is consistent with current statutory guidance. It expands on current statutory guidance to address the accounting for ESOPs in greater detail and to expand the disclosure requirements for ESOPs.
21. This issue paper adopts the GAAP guidance set forth in SOP 93-6 except for:

a. Paragraphs 13 and 25 to the extent that those paragraphs require reporting all debt obligations of an ESOP as liabilities. Statutory accounting provides an exception in situations where the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. Pursuant to current statutory guidance and Issue Paper No. 80, such obligations do not meet the definition of liabilities (of the sponsor) as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets.

b. Paragraphs 28 through 34 and paragraphs 44 and 53 b. as they relate to the calculation and reporting of earnings per share.

c. Paragraph 37 as it relates to reporting gains and losses on extinguishment of debt. Such gains and losses shall be accounted for and disclosed consistent with Issue Paper No. 24.

22. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Pursuant to Securities and Exchange Commission (SEC) Codification of Financial Reporting Policies, Section 211 - Redeemable Preferred Stocks, SEC reporting companies are required to report such securities outside of permanent equity for GAAP reporting purposes. The SEC states that there is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The SEC believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. There is no such requirement for non-SEC reporting companies. Paragraph 18 of this issue paper requires reporting of such securities consistent with the GAAP requirements for non-SEC reporting companies and is consistent with the accounting for capital stock as discussed in Issue Paper No. 72 - Statutory Surplus. Additionally, paragraph 19 of this issue paper requires disclosure of the existence and nature of any repurchase obligation. EITF 89-11 addresses the accounting for SEC reporting companies and is therefore rejected.

23. This issue paper is consistent with the reporting of ESOP debt as discussed in Issue Paper No. 80.

24. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

25. The P & C Accounting Practices and Procedures Manual, Chapter 13 and the Life/A&H Accounting Practices and Procedures Manual, Chapter 17 include the following guidance in (only the pertinent excerpts are included below):
Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

Generally Accepted Accounting Principles

26. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Scope

1. This statement of position (SOP) provides guidance on employers’ accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.¹

¹ Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans.

2. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

3. This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, Accounting Practices for Certain Employee Stock Ownership Plans, and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D of this SOP.

Background

4. SOP 76-3 was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

5. Since the issuance of SOP 76-3, Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in Appendix C, were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.²

² Statistics from an unpublished study completed in 1991 by the National Center for Employer Ownership, Oakland, Calif.

6. The increase in the number of ESOPs since the issuance of SOP 76-3 was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 was issued. These include the following:
• To fund a matching program for a sponsor’s 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
• To raise new capital or to create a marketplace for the existing stock
• To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
• To be part of the financing package in leveraged buy-outs
• To provide a tax-advantaged means for owners to terminate their ownership
• To be part of a long-term program to restructure the equity section of a plan sponsor’s balance sheet
• To defend the company against hostile takeovers

7. The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

8. Employers’ accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 was issued, there was disagreement about some ESOP issues. Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3. Furthermore, SOP 76-3 does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

9. Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 and to consider current ESOP issues that are not specifically addressed in the accounting literature. AcSEC’s objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

10. There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

11. The following conclusions should be read in conjunction with the “Discussion of Conclusions” beginning with paragraph 59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer’s shares. The shares initially held by the ESOP in a suspense account are called suspense shares. The debt is generally repaid by the ESOP from employer contributions and dividends on the employer’s stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP’s fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without

3 Paragraph 13 of SOP 76-3 presents a minority view that disagrees with that SOP’s recommendations on reporting dividends paid and earnings per share.

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a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

\[\text{Terms defined in the glossary are in italicized type the first time they appear in this SOP.}\]

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting the Release of ESOP Shares

14. ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on allocated shares that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values\(^5\) of committed-to-be-released shares.

\[\text{Paragraph 20 of this SOP contains guidance on fair value.}\]

15. Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP’s suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

16. Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be released to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

17. Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities
associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

18. The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace dividends on previously allocated shares used for debt service, employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs 21 and 22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer’s interpretation of current IRS regulations.

19. Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders’ equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

20. The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer’s best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer’s year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

21. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

22. Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP’s suspense account to participant accounts (see paragraph 18).

Reporting Redemptions of ESOP Shares

23. Regardless of whether an ESOP is leveraged of nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.
Employee Stock Ownership Plans

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- **Direct loan** — A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- **Indirect loan** — A loan made by the employer to the ESOP, with a related outside loan to the employer.
- **Employer loan** — A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

28. For purposes of computing primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

29. Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- Whether convertible preferred shares held by an ESOP should be considered common stock equivalents
- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods’ EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute EPS and does not address all possible EPS questions that may arise. Accounting Principles Board (APB) Opinion No. 15, *Earnings per Share*; the AICPA’s accounting Interpretations of that Opinion; and illustrations 4 and 5 in appendix A of this SOP provide additional guidance.
30. **Common Stock Equivalents.** APB Opinion No. 15 requires that a convertible security, which at the time of issuance has terms that make it for all practical purposes substantially the equivalent to a common stock, should be regarded as a common stock equivalent. For convertible preferred stock not held by an ESOP, an effective yield test is applied to the securities at the time of issuance to determine whether the securities should be considered common stock equivalents. However, the terms of convertible preferred shares held by ESOPs generally differ from other convertible preferred stock in two ways:

   a. Convertible preferred shares held by ESOPs generally cannot remain outstanding indefinitely.

   b. ESOP participants cannot withdraw their convertible preferred shares from the plan; the terms generally require participants to redeem the shares with the employer or convert the shares to common stock when participants withdraw their account balances from the ESOP plan. (Whether a participant chooses redemption of conversion depends on the value of the employer’s common stock in relation to the stated minimum value of the convertible preferred stock.)

ESOP shares with such characteristics should always be considered common stock equivalents. However, if the convertible preferred shares held by an ESOP may be withdrawn from the plan and sold to someone other than the employer or other ESOP participants, the employer should apply the effective yield test to determine whether the shares should be considered common stock equivalents.

31. **Number of Shares Outstanding.** Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. For ESOP shares considered common stock equivalents, the number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for both primary and fully diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for both primary and fully diluted EPS.

32. When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares of a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash. In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (a) the shares issuable at the stated conversion rate and (b) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed for primary earnings based on the ratio of (a) the average fair value of the convertible stock or, if greater, its stated minimum value, to (b) the average fair value of the common stock. For fully diluted EPS, the ratio should be (a) the end-of-period fair value of the convertible stock or, if greater, the stated minimum value, to (b) the end-of-period value of the common stock, if that ratio is more dilutive than the primary EPS ratio. The appropriate ratios should then be applied to the shares issuable at the state conversion rate to determine the number of shares issuable on assumed withdrawal.

6 Financial Accounting Standards Board (FASB) Interpretation No. 31, *Treatment of Stock Compensation Plan in EPS Computations*, used such a presumption for stock appreciation rights and other variable plan awards.
33. **Adjustments to Earnings.** Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

34. **Changes in Conversion Rates.** In consonance with paragraphs 56 through 58 of APB Opinion 15, prior period EPS should not be restated for changes in the conversion rates.

**Accounting for Terminations**

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, requires that difference to be included in the employer's income when the debt is extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

**Nonleveraged ESOPs**

40. An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP’s fiscal year.
41. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

42. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

43. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

44. All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer’s EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs 29 to 34 of this SOP for leveraged ESOPs should be considered.

45. An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

46. If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

47. Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

48. If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs 14 to 18).
Issues Related to Accounting for Income Taxes

Leveraged ESOPs

49. For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (a) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (b) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with FASB Statement No. 109, Accounting for Income Taxes. Similar differences arise from employee stock options. Paragraph 36e of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders’ equity.

50. In accordance with paragraph 36e of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders’ equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders’ equity to the extent of previous credits to shareholders’ equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

51. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations. Under paragraph 36f of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders’ equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36f of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

52. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference under Statement No. 109.

Disclosures

53. An employer sponsoring an ESOP should disclose the following information about the plan, if applicable:

a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used.

b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in the SOP is required (see paragraphs 54 and 55), the accounting policies for both blocks of shares shall be described.
c. The amount of compensation cost recognized during the period.

d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs 54 and 55).

e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP’s cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs 55 and 56).

f. The existence and nature of any repurchase obligation, including disclosure of the fair value\(^7\) of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

\(^7\) See paragraph 20 for guidance on fair value.

### RELEVANT LITERATURE

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 24 - Discontinued Operations and Extraordinary Items
- Issue Paper No. 72 - Statutory Surplus
- Issue Paper No. 80 - Debt
- Issue Paper No. 83 - Accounting for Income Taxes

**Generally Accepted Accounting Principles**
- AICPA Statement of Position 93-6, *Employers’ Accounting for Employee Stock Ownership Plans.*
- FASB Emerging Issues Task Force Issue No. 89-11, *Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 211 - Redeemable Preferred Stocks
Statutory Issue Paper No. 80

Debt

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for debt is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt be reported at the unpaid amount at the balance sheet date. Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate. Additionally, debt obligations of Employee Stock Ownership Plans (“ESOP”) must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. See Issue Paper No. 41 - Surplus Notes (Issue Paper No. 41) for discussion of surplus notes.

2. GAAP addresses accounting for debt in Accounting Principles Board Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants (APB 14), Accounting Principles Board Opinion No. 21, Interest on Receivables and Payables (APB 21), Accounting Principles Board Opinion No. 26, Early Extinguishment of Debt (APB 26), FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt (FAS 4), FASB Statement No. 47, Disclosure of Long Term Obligations (FAS 47), FASB Statement No. 76, Extinguishment of Debt (FAS 76), FASB Statement No. 84, Induced Conversions of Convertible Debt (FAS 84) and in AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans (SOP 93-6).

3. The purpose of this issue paper is to establish statutory accounting principles for debt that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Debt shall be reported as a liability unless it is debt on real estate (i.e., reported as a reduction in the carrying value of real estate) in accordance with Issue Paper No. 40 - Real Estate Investments (Issue Paper No. 40), or is offset against another asset in accordance with Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities (Issue Paper No. 76) or is specified elsewhere within the codification. Instruments that meet the requirements to be recorded as surplus as specified in Issue Paper No. 41 - Surplus Notes, are not considered debt. Interest on debt shall be accrued over the life of the debt and charged to operations, except when capitalized in accordance with Issue Paper No. 44 - Capitalization of Interest (Issue Paper No. 44). Interest payable shall include interest payable on all debt reported as a liability, approved interest on surplus notes and interest payable on debt reported as a reduction in the carrying value of real estate.

5. Debt discount or premium, if any, shall be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. Such discount or premium shall be amortized over the life of the note using the interest method.
6. Debt issuance costs (i.e., loan fees, legal fees, etc.) do not meet the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Accordingly, such costs shall be charged to operations.

7. Debt obligations of ESOPs shall be reported as borrowed money by company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company’s securities. ESOPs are addressed in Issue Paper No. 78 - Employee Stock Ownership Plans.

8. Debt which is subject to a troubled debt restructuring shall be accounted for in accordance with Issue Paper No. 36 - Troubled Debt Restructurings (Issue Paper No. 36).

9. Convertible debt securities that are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price not significantly in excess of the face amount shall be accounted for solely as debt at the time of issuance. An expense shall be recognized, equal to the fair value of additional securities granted or other consideration issued to induce conversion subsequent to the issuance of convertible debt securities.

10. Proceeds from debt issued with detachable stock purchase warrants shall be allocated based on the relative fair value of the two securities at the time of issuance. The value attributable to the warrants shall be accounted for as paid-in capital.

11. Other types of debt securities shall be accounted for in accordance with the substance of the transaction.

12. Debt shall be considered extinguished if the debtor is relieved of primary liability for the debt by the creditor and it is probable that the debtor will not be required to make future payments as guarantor of the debt. Even if the creditor does not relieve the debtor of its primary obligation, such debt shall be considered extinguished if the debtor irrevocably places cash or other monetary assets (that are essentially risk free as to the amount, timing, and collection of interest and principal) in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. The monetary assets held by the trust shall provide cash flows (from interest and maturity of those assets) that approximately coincide, as to timing and amount, with the scheduled interest and principal payments on the debt that is being extinguished. Gains and losses from extinguishment of debt are capital gains or losses, and shall be charged to operations in accordance with Issue Paper No. 24 - Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

13. The financial statements or notes thereto shall disclose the following items related to debt:
   - date issued;
   - pertinent information concerning the kind of borrowing (e.g. debentures, commercial paper outstanding, bank loans, lines of credit, etc.);
   - face amount of the debt;
   - carrying value of debt;
   - the rate at which interest accrues;
   - the effective interest rate;
   - the combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented;
   - collateral requirements;
   - a summary of significant debt terms and covenants and any violations;
   - interest paid in the current year;
• if debt was considered to be extinguished by in-substance defeasance prior to the effective date of this issue paper and any of the debt remains outstanding, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period; and
• if assets are set aside after the effective date of this issue paper solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets

DISCUSSION

14. This issue paper adopts current statutory guidance for debt. It expands on current statutory guidance to address the accounting for debt discount and premium, debt issuance costs, convertible debt securities, debt issued with detachable stock purchase warrants and extinguishment of debt. It also expands current statutory guidance to address disclosure requirements regarding the carrying value of the debt, effective interest rate, combined aggregate amount of maturities and sinking fund requirements for each of the five years following the latest balance sheet presented and interest paid in the current year.

15. This issue paper adopts APB 14 and FAS 84. The requirement in paragraph 13 to disclose the aggregate amount of maturities and sinking fund requirements for each of the next five years is consistent with subparagraph 10b of FASB Statement No. 47, Disclosure of Long Term Obligations.

16. This issue paper adopts APB 21 with a modification to require that debt issuance costs be charged to operations. These costs represent deferred charges which are immediately expensed for statutory accounting, whereas GAAP requires that such costs be reported on the balance sheet as deferred charges and be recognized over the period of the borrowing as an adjustment to the effective interest rate. Immediately expensing debt issuance costs is consistent with the Statement of Concepts which states “Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment”.

17. This issue paper rejects FAS 4 and and FASB Statement No. 64, Extinguishment of Debt Made to Satisfy Sinking Fund Requirements—an Amendment of FASB Statement No. 4. This issue paper also rejects FASB Emerging Issues Task Force No. 84-40, Long-Term Debt Repayable by a Capital Stock.

18. This issue paper adopts APB 26 with modification to require that gains and losses from extinguishment of debt be reported as capital gains or losses, and charged to operations in accordance with Issue Paper No. 24. This issue paper adopts paragraphs 13 and 25 of SOP 93-6 with a modification to exclude debt obligations when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company or the sale or exchange of the company’s securities. Such obligations do not meet the definition of liabilities (of the sponsor) as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). This issue paper rejects paragraph 37 of SOP 93-6 as it relates to reporting gain and losses on extinguishment of debt. Such gains and losses shall be accounted for consistent with Issue Paper No. 24. SOP 93-6 will be addressed in its entirety in Issue Paper No. 78.

19. This issue paper adopts FASB Emerging Issues Task Force No. 90-19, Convertible Bonds with Issuer Option to Settle for Cash upon Conversion, with a modification to reject guidance related to earnings per share and FASB Technical Bulletin No. 80-1, Early Extinguishment of Debt through Exchange for Common or Preferred Stock, with a modification to reject guidance related to classification of the loss as an extraordinary item.
20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstance (such pronouncements are not reproduced herein due to length and limited scope):

Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, Omnibus Opinion – 1967
AICPA Accounting Interpretations of APB 21, Interest on Receivables and Payables
AICPA Accounting Interpretations of APB 26, Early Extinguishment of Debt
FASB Emerging Issues Task Force No. 85-9, Revenue Recognition on Options to Purchase Stock of Another Entity
FASB Emerging Issues Task Force No. 85-17, Accrued Interest upon Conversion of Convertible Debt
FASB Emerging Issues Task Force No. 85-29, Convertible Bonds with a “Premium Put”
FASB Emerging Issues Task Force No. 86-8, Sale of Bad-Debt Recovery Rights
FASB Emerging Issues Task Force No. 86-15, Increasing-Rate Debt
FASB Emerging Issues Task Force No. 86-18, Debtor’s Accounting for a Modification of Debt Terms
FASB Emerging Issues Task Force No. 86-28, Accounting Implications of Indexed Debt Instruments
FASB Emerging Issues Task Force No. 86-36, Invasion of a Defeasance Trust
FASB Emerging Issues Task Force No. 95-15, Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount

21. This issue paper is consistent with the reporting for surplus notes as addressed in Issue Paper No. 41, the reporting of encumbrances on real estate as discussed in Issue Paper No. 40, the offsetting of assets and liabilities as addressed in Issue Paper No. 76 and the reporting of gains and losses on troubled debt restructurings as discussed in Issue Paper No. 36.

22. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

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

Drafting Notes/Comments

- Reverse repurchase agreements are addressed in Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements.
- Pledged assets are addressed in Issue Paper No. 77 - Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
23. The P & C Accounting Practices and Procedures Manual includes the following guidance in Chapter 13 (only the pertinent excerpts are included below):
Borrowed Money

Borrowed money includes liabilities for loans except those secured by mortgages on company real estate and surplus loans. The amount to be reported is the amount unpaid at the balance sheet date. Resolution authorizing borrowed money are usually shown in the minutes of the board of directors, executive, investment, or finance committees.

Loans secured by mortgages on company real estate are treated as a reduction from the asset value of such real estate rather than as “Borrowed Money.” For further discussion, see Chapter 4-Real Estate.

Surplus loans, i.e., subordinated surplus debentures, are covered in Chapter 24-Paid-In or Contributed Surplus.

Interest Payable

Interest payable includes interest on “Borrowed Money” as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22-Reinsurance.

The interest on “Borrowed Money” is also shown parenthetically as part of the caption of this liability item in the annual statement.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

24. The Life/A&H Accounting Practices and Procedures Manual includes the following guidance in Chapter 17 (only the pertinent excerpts are included below):

Borrowed Money

Borrowed money is debt, other than subordinated surplus debentures, contribution notes, or similar indebtedness. The amount to be reported is the amount unpaid at the balance sheet date plus the related accrued interest. See Chapter 27 for a discussion of subordinated surplus debentures, etc.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP’s must record the debt obligations of such ESOP’s on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company’s stock, contributions from the company, or the sale or exchange of the company’s securities.

25. The NAIC Annual Statement Instructions (Annual Statement Instructions) for Property and Casualty Insurance Companies provide the following guidance. Substantially similar guidance is provided in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.

7. Borrowed Money

Instruction:

Furnish pertinent information concerning the kind of borrowing (e.g., debentures, commercial paper outstanding, bank loan, lines of credit, etc.). Indicate redemption price, if any, interest
features, collateral requirements, maturity date, etc., for money borrowed by the company. Also include information regarding material loan provisions (i.e., covenants) that must be satisfied or maintained on a continuing basis and indicate if the society is in violation of any such loan provisions. Identify the terms of reverse repurchase agreements whose amounts have been included in the liability for borrowed money.

**Generally Accepted Accounting Principles**

26. APB 14 provides the following guidance (only the pertinent excerpts are included below):

CONVERTIBLE DEBT

Discussion

3. Convertible debt securities discussed herein are those debt securities which are convertible into common stock of the issuer or an affiliated company at a specified price at the option of the holder and which are sold at a price or have a value at issuance not significantly in excess of the face amount. The terms of such securities generally include (1) an interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance, and (3) a conversion price which does not decrease except pursuant to antidilution provisions. In most cases such securities also are callable at the option of the issuer and are subordinated to nonconvertible debt.

7. The most important reason given for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. Furthermore the two choices are mutually exclusive; they cannot both be consummated. Thus, the security will either be converted into common stock or be redeemed for cash. The holder cannot exercise the option to convert unless he forgoes the right to redemption, and vice versa.

Opinion

12. The Board is of the opinion that no portion of the proceeds from the issuance of the types of convertible debt securities described in paragraph 3 should be accounted for as attributable to the conversion feature. In reaching this conclusion, the Board places greater weight on the inseparability of the debt and the conversion option (as described in paragraph 7) and less weight on practical difficulties.

DEBT WITH STOCK PURCHASE WARRANTS

Opinion

16. The Board is of the opinion that the portion of the proceeds of debt securities issued with detachable stock purchase warrants which is allocable to the warrants should be accounted for as paid-in capital. The allocation should be based on the relative fair values of the two securities at time of issuance. Any resulting discount or premium on the debt securities should be accounted for as such. The same accounting treatment applies to issues of debt securities (issued with detachable warrants) which may be surrendered in settlement of the exercise price of the warrant. However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and the accounting specified in paragraph 12 should apply.
2 The time of issuance generally is the date when agreement as to terms has been reached and announced, even though the agreement is subject to certain further actions, such as directors’ or stockholders’ approval. APB 14 Footnote 3

3 See Chapter 15 of ARB No. 43 (as amended by paragraph 19 of APB Opinion No. 6 and paragraph 17 of APB Opinion No. 9) and paragraphs 16 and 17 of APB Opinion No. 12.

17. When detachable warrants are issued in conjunction with debt as consideration in purchase transactions, the amounts attributable to each class of security issued should be determined separately, based on values at the time of issuance.² The debt discount or premium is obtained by comparing the value attributed to the debt securities with the face amount thereof.

OTHER TYPES OF DEBT SECURITIES

Opinion

18. The Board recognizes that it is not practicable in this Opinion to discuss all possible types of debt with conversion features, debt issued with stock purchase warrants, or debt securities with a combination of such features. Securities not explicitly discussed in this Opinion should be dealt with in accordance with the substance of the transaction. For example, when convertible debt is issued at a substantial premium, there is a presumption that such premium represents paid-in capital.

APB 21 provides the following guidance (only the pertinent excerpts are included below):

Opinion

15. Amortization of discount and premium. With respect to a note which by the provisions of this Opinion requires the imputation of interest, the difference between the present value and the face amount should be treated as discount or premium⁸ and amortized as interest expense or income over the life of the note in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period. This is the “interest” method described in and supported by paragraphs 16 and 17 of APB Opinion No. 12, Omnibus Opinion–1967. However, other methods of amortization may be used if the results obtained are not materially different from those which would result from the “interest” method.

⁸ Differences between the recognition for financial accounting purposes and income tax purposes of discount or premium resulting from determination of the present value of a note should be treated as timing differences in accordance with APB Opinion No. 11, Accounting for Income Taxes.

16. Statement presentation of discount and premium. The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.⁹ Amortization of discount or premium should be reported as interest in the statement of income. Issue costs should be reported in the balance sheet as deferred charges.

⁹ Refer to the Appendix for illustrations of balance sheet presentation.
28. APB 26 provides the following guidance (only the pertinent excerpts are included below):

Opinion

19. Reduction of alternatives. The Board concludes that all extinguishments of debt before scheduled maturities are fundamentally alike. The accounting for such transactions should be the same regardless of the means used to achieve the extinguishment.

20. Disposition of amounts. A difference between the reacquisition price and the net carrying amount of the extinguished debt should be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item. The criteria in APB Opinion No. 9 should be used to determine whether the losses or gains are ordinary or extraordinary items. Gains and losses should not be amortized to future periods.

21. Convertible debt. The extinguishment of convertible debt before maturity does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

29. FAS 47 provides the following guidance (only the pertinent excerpts are included below):

10. The following information shall be disclosed for each of the five years following the date of the latest balance sheet presented:

b. The combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings

30. FAS 84 provides the following guidance (only the pertinent excerpts are included below):

APPLICABILITY AND SCOPE

2. This Statement applies to conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion. This Statement applies only to conversions that both (a) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (b) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted. The changed terms may involve reduction of the original conversion price thereby resulting in the issuance of additional shares of stock, issuance of warrants or other securities not provided for in the original conversion terms, or payment of cash or other consideration to those debt holders who convert during the specified time period. This Statement does not apply to conversions pursuant to other changes in conversion privileges or to changes in terms of convertible debt instruments that are different from those described in this paragraph.

For purposes of this Statement, a conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt.
STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Recognition of Expense upon Conversion

3. When convertible debt is converted to equity securities of the debtor pursuant to an inducement offer described in paragraph 2 of this Statement, the debtor enterprise shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The expense shall not be reported as an extraordinary item.

4. The fair value of the securities or other consideration shall be measured as of the date the inducement offer is accepted by the convertible debt holder. Normally this will be the date the debt holder converts the convertible debt into equity securities or enters into a binding agreement to do so.

31. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer’s shares. The shares initially held by the ESOP in a suspense account are called suspense shares.4 The debt is generally repaid by the ESOP from employer contributions and dividends on the employer’s stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP’s fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

4 Terms defined in the glossary are in italicized type the first time they appear in this SOP.

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- Direct loan - A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- Indirect loan - A loan made by the employer to the ESOP, with a related outside loan to the employer.
- Employer loan - A loan made by the employer to the ESOP, with no related outside loan.
ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer’s financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP’s note payable and the employer’s note receivable in the employer’s balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring a ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, Early Extinguishment of Debt, as amended by FASB Statement of Financial Accounting Standards No. 4, Reporting Gains and Losses from Extinguishement of Debt, requires that difference to be included in the employer’s income when the debt in extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14 to 18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.
RELEVANT LITERATURE

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies, Chapter 4, Real Estate and Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 4, Real Estate and Chapter 13, Other Liabilities
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 23 - Property Occupied by the Company
- Issue Paper No. 24 - Discontinued Operations and Extraordinary Items
- Issue Paper No. 36 - Troubled Debt Restructurings
- Issue Paper No. 40 - Real Estate Investments
- Issue Paper No. 41 - Surplus Notes
- Issue Paper No. 44 - Capitalization of Interest
- Issue Paper No. 45 - Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities

**Generally Accepted Accounting Principles**
- Accounting Principles Board Opinion No. 12, paragraphs 16 and 17, *Omnibus Opinion – 1967*
- Accounting Principles Board Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
- Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*
- Accounting Principles Board Opinion No. 26, *Early Extinguishment of Debt*
- FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*
- FASB Statement No. 47, *Disclosure of Long Term Obligations*
- FASB Statement No. 64, *Extinguishment of Debt Made to Satisfy Sinking Fund Requirements— an Amendment of FASB Statement No. 4*
- FASB Statement No. 84, *Induced Conversions of Convertible Debt*
- AICPA Statement of Position 93-6, *Employers’ Accounting for Employee Stock Ownership Plans*
- AICPA Accounting Interpretations of APB 21, *Interest on Receivables and Payables*
- AICPA Accounting Interpretations of APB 26, *Early Extinguishment of Debt*
- FASB Emerging Issues Task Force No. 84-40, *Long-Term Debt Repayable by a Capital Stock*
- FASB Emerging Issues Task Force No. 85-9, *Revenue Recognition on Options to Purchase Stock of Another Entity*
- FASB Emerging Issues Task Force No. 85-17, *Accrued Interest upon Conversion of Convertible Debt*
- FASB Emerging Issues Task Force No. 85-29, *Convertible Bonds with a “Premium Put”*
- FASB Emerging Issues Task Force No. 86-8, *Sale of Bad-Debt Recovery Rights*
- FASB Emerging Issues Task Force No. 86-15, *Increasing-Rate Debt*
- FASB Emerging Issues Task Force No. 86-18, *Debtor’s Accounting for a Modification of Debt Terms*
- FASB Emerging Issues Task Force No. 86-28, *Accounting Implications of Indexed Debt Instruments*
- FASB Emerging Issues Task Force No. 86-36, *Invasion of a Defeasance Trust*
- FASB Emerging Issues Task Force No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*
- FASB Emerging Issues Task Force No. 95-15, *Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount*
- FASB Technical Bulletin No. 80-1, *Early Extinguishment of Debt through Exchange for Common or Preferred Stock*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 81

Foreign Currency Transactions and Translations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. A foreign currency transaction is a transaction denominated in a currency other than the reporting entity’s functional currency. The reporting entity’s functional currency is defined as the currency of the primary economic environment in which the reporting entity operates. Foreign currency translation is the translation of financial statements, denominated in the reporting entity’s functional currency, into U.S. dollars prior to their incorporation into financial statements through consolidation or the equity method of accounting.

2. Current statutory guidance for accounting for foreign currency transactions is provided in Chapters 13 and 25 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and Chapter 8 of the Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). This guidance requires foreign currency transactions to be recorded in U.S. dollars at the exchange rate in effect at the time of the transaction. At each subsequent statement date, all net assets recorded in each foreign currency are converted to U.S. dollars at the exchange rate in effect at the statement date. Property and casualty insurers record a change in net assets due to changes in foreign exchange rates between the original transaction date and the current statement date as an additional and separate asset or liability with a corresponding adjustment made directly to surplus. Life and accident and health insurers record an additional and separate asset or liability with a corresponding entry to capital gain or loss.

3. Limited statutory guidance for accounting for foreign currency transactions is also provided in the Purposes and Procedures of the Securities Valuation Office of the NAIC (SVO Purposes and Procedures). This guidance requires that market values for securities payable in other than U.S. dollars to be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the Valuation of Securities Manual.

4. GAAP guidance for accounting for foreign currency transactions is provided in FASB Statement No. 52, Foreign Currency Translation (FAS 52). This guidance requires each asset, liability, revenue, expense, gain, or loss arising from a transaction to be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date. Subsequently, at each balance sheet date, assets and liabilities that are denominated in a currency other than the functional currency of the recording entity are adjusted to reflect the current exchange rate. Any changes in the assets or liabilities from the date of the original transaction to the balance sheet date resulting from exchange rate fluctuations, are included in net income for the period in which the change occurred.

5. GAAP guidance for accounting for foreign currency translation is also provided in FAS 52. This guidance requires all assets and liabilities to be translated at the exchange rate at the balance sheet date, while revenues, expenses, gains, and losses are translated at the exchange rate in effect at the dates on which the transactions were recognized. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.
6. The purpose of this issue paper is to establish statutory accounting principles for accounting for foreign currency transactions and translation that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

7. For the purposes of this issue paper, a U.S. domiciled entity’s reporting currency shall be defined as the U.S. dollar, regardless of the primary economic environment in which the reporting entity operates. In order to ensure consistency, all elements of statutory financial statements shall be reported in U.S. dollars.

8. Each foreign currency transaction shall be examined and a determination made if the foreign currency transaction was made in support of insurance operations denominated in the same foreign currency. For example, some reporting entities engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the reporting entity’s balance sheet. Premiums, reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the claim is incurred. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

9. Foreign currency transactions made in support of insurance operations denominated in the same foreign currency, such as foreign branches, shall be accounted for as follows:

a. **Canadian Insurance Operations**

   Canadian insurance operations, resulting in less than 10% of the reporting entity’s admitted assets, less than 10% of the reporting entity’s liabilities and less than 10% of the reporting entity’s net premium, can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the reporting entity. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

b. **All Other Foreign Insurance Operations**

   All other foreign insurance operations must be translated to U.S. dollars as follows: each financial statement line shall be translated to U.S. dollars by applying the following exchange rates: 1) for assets and liabilities, the exchange rate at the balance sheet date shall be used and 2) for revenues, expenses, gains, losses and surplus adjustments, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, losses and surplus adjustments are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements. Gains or losses due to translating foreign operations to U.S. dollars shall be recorded as an unrealized capital gain or loss.
10. All other foreign currency transactions shall be accounted for as follows:

a. Assets and liabilities denominated in foreign currencies shall be accounted for at their U.S. dollar equivalent values using exchange rates at the balance sheet date. Income and expenses recognized during an accounting period shall be recorded at an appropriately weighted average exchange rate.

b. Changes in balance sheet asset and liability values due to fluctuations in foreign currency exchange rates shall be recorded as unrealized capital gains and losses until the asset is sold or exchanged or the liability is settled. Upon settlement, previously recorded unrealized capital gains and losses shall be reversed and the foreign exchange profit or loss for the entire holding period shall be recorded as a realized capital gain or loss.

c. Transactions involving settlement in cash, such as purchases, payment of expenses, sales, and receipt of income, shall be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, payment of expenses, sales, maturities or changes in income or expense accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity.

11. Nominal information such as par value of investments may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount should be used. The U.S. dollar equivalent amount is translated utilizing the exchange rate at the balance sheet date. Ratios and factors should be based on data that is entirely consistent with respect to currency.

12. A currency in a highly inflationary environment (one that has cumulative inflation of approximately 100% or more over a three year period) is not considered stable enough to serve as a functional currency and the more stable currency of the reporting parent is to be used instead. If a reporting entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. The remeasurement process is intended to produce the same result as if the reporting entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in recognized as a realized gain or loss in the statement of operations.

DISCUSSION

13. This issue paper rejects current statutory accounting principles. Current statutory guidance for property and casualty insurers provides that fluctuations in the value of assets and liabilities be summarized and recorded as a net asset or liability with an offsetting adjustment made directly to surplus. Current statutory guidance for life and accident and health insurers provides that fluctuations in the values of assets and liabilities be summarized and recorded as a net asset or liability with a corresponding entry recorded as a capital gain or loss. The conclusions reached in this issue paper require all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date with the corresponding entry recorded as an unrealized gain or loss (see paragraph 14 for reference to exemption for certain Canadian branch operations). This change to require life and accident and health insurers to reflect the translation gain or loss as unrealized was made to conform accounting treatment for the translation adjustment between property and casualty insurers and life and health insurers. Requiring all assets and liabilities to be translated at the exchange rate in effect at the balance sheet date provides more meaningful information to regulators and other financial statement users. The statutory principles outlined in the conclusion above are consistent with draft statutory guidance prepared by the Invested Assets Working Group of the Valuation of Securities (EX4) Task Force.
14. Subparagraph 9 a. of this issue paper affords different treatment to certain Canadian branch operations. As a matter of historic practice, U.S. reporting entities have treated Canadian branch operations in their statutory statements as if they were U.S. dollar denominated operations. This practice was established at a time when the Canadian and U.S. dollars were at or close to equivalent. The cost of translating each line item for immaterial Canadian operations is perceived to exceed the benefits of line-by-line exactness. Consideration has also been given to the impact on risk-based capital and the asset valuation reserve of reporting entities under the provisions of subparagraph 9 a. and the impact is not considered to be material.

15. The statutory principles outlined in the conclusion above are not consistent with current GAAP as follows:

   a. Subparagraph 9 a. Allows changes in balance sheet asset and liability values due to exchange rate fluctuations of a reporting entity’s Canadian insurance operations comprising less than 10% of the reporting entity’s admitted assets and liabilities and net premium to be recorded as unrealized capital gains or losses with a corresponding adjustment made to a net asset or liability. GAAP requires each asset and liability account to be adjusted.

   b. Paragraph 10 allows changes in balance sheet asset and liability values due to exchange rate fluctuations to be recorded as unrealized capital gains or losses. GAAP requires that fluctuations in asset values that arose as a result of transactions denominated in a foreign currency be recorded as part of net income. GAAP requires that a gain or loss resulting from translating the financial statements of an operation that has a functional currency other than the U.S. dollar be recorded as unrealized. Recording gains and losses as a result of fluctuations in exchange rates as unrealized gains and losses for statutory purposes affords these fluctuations the same accounting treatment as fluctuations in the market values of equity securities.


16. The statutory principles outlined in the conclusion above are consistent with the recognition and consistency concepts in the Statement of Concepts. Pertinent excerpts follow:

   Consistency
   The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

   Recognition
   The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise.
Drafting Notes/Comments
- Forward exchange contracts are addressed in a separate issue paper.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
17. The P&C Accounting Practices and Procedures Manual, Chapter 13, Other Liabilities, provides the following guidance:

Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates

An insurance company may have assets or liabilities payable in foreign currencies.

Differences between the exchange rates when the original entries were recorded and the current statement date result in changes in net asset value. Reductions in net asset value are shown under this caption, while increases are recorded as an asset under aggregate write-ins for other than invested assets. If different foreign currencies are involved, the assets and liabilities must be segregated accordingly and applied against the proper exchange rate. The exchange rates to be used are those published in the NAIC Valuation of Securities manual.

18. The P&C Accounting Practices and Procedures Manual, Chapter 25, Unassigned Funds (Surplus) provides the following guidance with respect to foreign exchange adjustments:

Change in Foreign Exchange Adjustment

Assets and liabilities in foreign currency are subject to adjustment to the prevailing foreign exchange rate. The change in the foreign exchange adjustment between the current and prior statement is charged or credited directly to unassigned surplus. (See Chapter 13-Other Liabilities.)

19. The Life/A&H Accounting Practices and Procedures Manual, Chapter 8, Other Admitted Assets, provides the following guidance:

Foreign Exchange Adjustment

Some insurers engage in operations in foreign countries, with the premiums collected and claims paid in the local currency. As in any insurance operations there will at all times be uncollected premiums, policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer’s balance sheet in the annual statement.

For ease in maintaining policy records, the premiums, reserves and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars. Because of the constant fluctuations in the foreign currencies’ exchange rates, it may be confusing and unduly burdensome to adjust individual policy and claims records to current rates. Most companies, therefore, make such adjustment to the net balance of the assets and liabilities in each foreign currency.

The adjustment is calculated by summarizing the assets and liabilities in each foreign currency and in U.S. dollars, as recorded in the company’s policy and claim records. The net value in the foreign currency is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in adjustment of the net value to current exchange rates is recorded as a separate asset or liability if the current rate is greater or less than the rate used by the company.

Change in foreign exchange adjustments generally are reported as capital gain or loss.
20. The SVO Purposes and Procedures Manual, Section 1, provides the following guidance:

Market values for securities payable in other than U.S. dollars will be computed by obtaining a quotation in the foreign currency from a reputable source and converting that quotation into U.S. dollars using the exchange rates published in the VOS Manual.

Generally Accepted Accounting Principles
21. FAS 52 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Objectives of Translation

4. Financial statements are intended to present information in financial terms about the performance, financial position, and cash flows of an enterprise. For this purpose, the financial statements of separate entities within an enterprise, which may exist and operate in different economic and currency environments, are consolidated and presented as though they were the financial statements of a single enterprise. Because it is not possible to combine, add, or subtract measurements expressed in different currencies, it is necessary to translate into a single reporting currency ² those assets, liabilities, revenues, expenses, gains, and losses that are measured or denominated in a foreign currency ³. However, the unity presented by such translation does not alter the underlying significance of the results and relationships of the constituent parts of the enterprise. It is only through the effective operation of its constituent parts that the enterprise as a whole is able to achieve its purpose. Accordingly, the translation of the financial statements of each component entity of an enterprise should accomplish the following objectives:

a. Provide information that is generally compatible with the expected economic effects of a rate change on an enterprise's cash flows and equity
b. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles

² For convenience, this Statement assumes that the enterprise uses the U.S. dollar (dollar) as its reporting currency. However, a currency other than the dollar may be the reporting currency in financial statements that are prepared in conformity with U.S. generally accepted accounting principles. For example, a foreign enterprise may report in its local currency in conformity with U.S. generally accepted accounting principles. If so, the requirements of this Statement apply.

³ To measure in foreign currency is to quantify an attribute of an item in a unit of currency other than the reporting currency. Assets and liabilities are denominated in a foreign currency if their amounts are fixed in terms of that foreign currency regardless of the exchange rate changes. An asset or liability may be both measured and denominated in one currency, or it may be measured in one currency and denominated in another. To illustrate: Two foreign branches of a U.S. Company, one Swiss and one German, purchase identical assets on credit from a Swiss vendor at identical prices stated in Swiss francs. The German branch measures the cost (an attribute) of that asset in German marks. Although the corresponding liability is also measured in marks, it remains denominated in Swiss francs since the liability must be settled in a specific number of Swiss francs. The Swiss branch measures the asset and liability in Swiss francs. Its liability is both measured and denominated in Swiss francs. Although assets and liabilities can be measured in various currencies, rights to receive or obligations to pay fixed amounts of a currency are, by definition, denominated in that currency.

The Functional Currency

5. The assets, liabilities, and operations of a foreign entity shall be measured using the functional currency of that entity. An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. Appendix A provides guidance for determination of the functional currency. The economic factors cited in Appendix A,
and possibly others, should be considered both individually and collectively when determining the functional currency.

6. For an entity with operations that are relatively self-contained and integrated within a particular country, the functional currency generally would be the currency of that country. However, a foreign entity's functional currency might not be the currency of the country in which the entity is located. For example, the parent's currency generally would be the functional currency for foreign operations that are a direct and integral component or extension of the parent company's operations.

7. An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

8. The functional currency (or currencies) of an entity is basically a matter of fact, but in some instances the observable facts will not clearly identify a single functional currency. For example, if a foreign entity conducts significant amounts of business in two or more currencies, the functional currency might not be clearly identifiable. In those instances, the economic facts and circumstances pertaining to a particular foreign operation shall be assessed in relation to the Board's stated objectives for foreign currency translation (paragraph 4). Management's judgment will be required to determine the functional currency in which financial results and relationships are measured with the greatest degree of relevance and reliability.

9. Once the functional currency for a foreign entity is determined, that determination shall be used consistently unless significant changes in economic facts and circumstances indicate clearly that the functional currency has changed. Previously issued financial statements shall not be restated for any change in the functional currency.

10. If an entity's books of record are not maintained in its functional currency, remeasurement into the functional currency is required. That remeasurement is required before translation into the reporting currency. If a foreign entity's functional currency is the reporting currency, remeasurement into the reporting currency obviates translation. The remeasurement process is intended to produce the same result as if the entity's books of record had been maintained in the functional currency. The remeasurement of and subsequent accounting for transactions denominated in a currency other than the functional currency shall be in accordance with the requirements of this Statement (paragraphs 15 and 16). Appendix B provides guidance for remeasurement into the functional currency.

The Functional Currency in Highly Inflationary Economies

11. The financial statements of a foreign entity in a highly inflationary economy shall be remeasured as if the functional currency were the reporting currency. Accordingly, the financial statements of those entities shall be remeasured into the reporting currency according to the requirements of paragraph 10. For the purposes of this requirement, a highly inflationary economy is one that has cumulative inflation of approximately 100 percent or more over a 3-year period.

Translation of Foreign Currency Statements

12. All elements of financial statements shall be translated by using a current exchange rate. For assets and liabilities, the exchange rate at the balance sheet date shall be used. For revenues, expenses, gains, and losses, the exchange rate at the dates on which those elements are recognized shall be used. Because translation at the exchange rates at the dates the numerous revenues, expenses, gains, and losses are recognized is generally impractical, an appropriately weighted average exchange rate for the period may be used to translate those elements.
13. If an entity’s functional currency is a foreign currency, translation adjustments result from the process of translating that entity’s financial statements into the reporting currency. Translation adjustments shall not be included in determining net income but shall be reported separately and accumulated in a separate component of equity.

14. Upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity, the amount attributable to that entity and accumulated in the translation adjustment component of equity shall be removed from the separate component of equity and shall be reported as part of the gain or loss on sale or liquidation of the investment for the period during which the sale or liquidation occurs.

Foreign Currency Transactions

15. Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of the amount of foreign currency that will be received or paid. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes. Likewise, a transaction gain or loss (measured from the transaction date or the most recent intervening balance sheet date, whichever is later) realized upon settlement of a foreign currency transaction generally shall be included in determining net income for the period in which the transaction is settled. The exceptions to this requirement for inclusion in net income of transaction gains and losses are set forth in paragraphs 20 and 21 and pertain to certain intercompany transactions and to transactions that are designated as, and effective as, economic hedges of net investments and foreign currency commitments.

16. For other than forward exchange contracts (paragraphs 17-19), the following shall apply to all foreign currency transactions of an enterprise and its investees:

a. At the date the transaction is recognized, each asset, liability, revenue, expense, gain, or loss arising from the transaction shall be measured and recorded in the functional currency of the recording entity by use of the exchange rate in effect at that date (paragraphs 26-28).

b. At each balance sheet date, recorded balances that are denominated in a currency other than the functional currency of the recording entity shall be adjusted to reflect the current exchange rate.

Transaction Gains and Losses to Be Excluded from Determination of Net Income

20. Gains and losses on the following foreign currency transactions shall not be included in determining net income but shall be reported in the same manner as translation adjustments (paragraph 13):

a. Foreign currency transactions that are designated as, and are effective as, economic hedges of a net investment in a foreign entity, commencing as of the designation date

b. Intercompany foreign currency transactions that are of a long-term-investment nature (that is, settlement is not planned or anticipated in the foreseeable future), when the entities to the transaction are consolidated, combined, or accounted for by the equity method in the reporting enterprise's financial statements

21. A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction (for example, the purchase or the sale of the equipment). Losses shall not
be deferred, however, if it is estimated that deferral would lead to recognizing losses in later periods. A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

a. The foreign currency transaction is designated as, and is effective as, a hedge of a foreign currency commitment.

b. The foreign currency commitment is firm.

The required accounting shall commence as of the designation date. The portion of a hedging transaction that shall be accounted for pursuant to this paragraph is limited to the amount of the related commitment. If a hedging transaction that meets conditions (a) and (b) above exceeds the amount of the related commitment, the gain or loss pertaining to the portion of the hedging transaction in excess of the commitment shall be deferred to the extent that the transaction is intended to provide a hedge on an after-tax basis. A gain or loss so deferred shall be included as an offset to the related tax effects in the period in which such tax effects are recognized; consequently, it shall not be included in the aggregate transaction gain or loss disclosure required by paragraph 30. A gain or loss pertaining to the portion of a hedging transaction in excess of the amount that provides a hedge on an after-tax basis shall not be deferred. Likewise, a gain or loss pertaining to a period after the transaction date of the related commitment shall not be deferred. If a foreign currency transaction previously considered a hedge of a foreign currency commitment is terminated before the transaction date of the related commitment, any deferred gain or loss shall continue to be deferred and accounted for in accordance with the requirements of this paragraph.

Exchange Rates

26. The exchange rate is the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time. If exchangeability between two currencies is temporarily lacking at the transaction date or balance sheet date, the first subsequent rate at which exchanges could be made shall be used for purposes of this Statement. If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the enterprise shall be carefully considered (ARB 43, Chapter 12, paragraph 8).

27. The exchange rates to be used for translation of foreign currency transactions and foreign currency statements are as follows:

a. Foreign Currency Transactions - The applicable rate at which a particular transaction could be settled at the transaction date shall be used to translate and record the transaction. At a subsequent balance sheet date, the current rate is that rate at which the related receivable or payable could be settled at that date.

b. Foreign Currency Statements - In the absence of unusual circumstances, the rate applicable to conversion of a currency for purposes of dividend remittances shall be used to translate foreign currency statements.\(^4\)

\(^4\) If unsettled intercompany transactions are subject to and translated using preference or penalty rates, translation of foreign currency statements at the rate applicable to dividend remittances may cause a difference between intercompany receivables and payables. Until that difference is eliminated by settlement of the intercompany transaction, the difference shall be treated as a receivable or payable in the enterprise’s financial statements.

28. If a foreign entity whose balance sheet date differs from that of the enterprise is consolidated or combined with or accounted for by the equity method in the financial statements of the enterprise, the current rate is the rate in effect at the foreign entity's balance sheet date for purposes of applying the requirements of this Statement to that foreign entity.
Use of Averages or Other Methods of Approximation

29. Literal application of the standards in this Statement might require a degree of detail in record keeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Accordingly, it is acceptable to use averages or other methods of approximation. For example, the propriety of using average rates to translate revenue and expense amounts is noted in paragraph 12. Likewise, the use of other time-and effort-saving methods to approximate the results of detailed calculations is permitted.

Disclosure

30. The aggregate transaction gain or loss included in determining net income for the period shall be disclosed in the financial statements or notes thereto. For that disclosure, gains and losses on forward contracts determined in conformity with the requirements of paragraphs 18 and 19 shall be considered transaction gains or losses. Certain enterprises, primarily banks, are dealers in foreign exchange. Although certain gains or losses from dealer transactions may fit the definition of transaction gains or losses in this Statement, they may be disclosed as dealer gains or losses rather than as transaction gains or losses.

31. An analysis of the changes during the period in the separate component of equity for cumulative translation adjustments shall be provided in a separate financial statement, in notes to the financial statements, or as part of a statement of changes in equity. At a minimum, the analysis shall disclose:
   a. Beginning and ending amount of cumulative translation adjustments
   b. The aggregate adjustment for the period resulting from translation adjustments (paragraph 13) and gains and losses from certain hedges and intercompany balances (paragraph 20)
   c. The amount of income taxes for the period allocated to translation adjustments (paragraph 24)
   d. The amounts transferred from cumulative translation adjustments and included in determining net income for the period as a result of the sale or complete or substantially complete liquidation of an investment in a foreign entity (paragraph 14)

32. An enterprise's financial statements shall not be adjusted for a rate change that occurs after the date of the enterprise's financial statements or after the date of the foreign currency statements of a foreign entity if they are consolidated, combined, or accounted for by the equity method in the financial statements of the enterprise. However, disclosure of the rate change and its effects on unsettled balances pertaining to foreign currency transactions, if significant, may be necessary.

OTHER SOURCES OF INFORMATION

22. The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force presented the following draft guidance to the Blanks Task Force:

Attachment A

NAIC ACCOUNTING PRINCIPLES
ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY
OTHER THAN INVESTMENTS HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

Investments denominated in foreign currencies other than investments held in support of insurance business denominated in the same foreign currency, should be accounted for at their
U.S. dollar equivalent values. Income recognized during an accounting period should be recorded at its weighted average U.S. dollar equivalent value, and balance sheet data should be recorded at its U.S. dollar equivalent value as of the balance sheet date.

Changes in balance sheet investment value due to foreign currency translation should be recorded as unrealized capital gains and losses on such investment until the investment is repaid or sold. Upon sale or repayment previously recorded unrealized capital gains and losses should be reversed and the foreign exchange profit or loss for the entire holding period should be recorded as a realized capital gain or loss.

Transactions involving settlement in cash, such as purchases, sales, and receipt of income, should be recorded at their U.S. dollar equivalent value based on the foreign currency exchange rate as of the transaction date. Any foreign currency exchange gains or losses on purchases, sales, maturities or changes in income accruals should be recorded as capital gain or loss realized on the purchase, sale or maturity or as adjustments to income respectively.

Nominal information such as par value may be expressed in the foreign currency or U.S. dollar equivalent (description of issue), but where the information is displayed comparatively (column of par values), U.S. dollar equivalent amount should be used. Ratios and factors should be based on data that is entirely consistent with respect to currency.

Attachment B

ACCOUNTING FOR INVESTMENTS DENOMINATED IN FOREIGN CURRENCY HELD IN SUPPORT OF INSURANCE BUSINESS DENOMINATED IN THE SAME FOREIGN CURRENCY

Some insurers engage in operations in foreign countries with the premiums collected and claims paid in local currency. As in any insurance operation there will at times be uncollected premiums policy reserves, unpaid claims, and other incomplete transactions that must be recorded in the insurer's balance sheet in the annual statement. For ease in maintaining policy records, the premiums reserves, and claims normally are recorded in U.S. dollars at the rate of exchange that is in effect at the time the policy is written, or when the company receives notification of the claim. Changes in exchange rates, while not affecting the foreign policyholder, do affect the value of the foreign business as it is recorded in U.S. dollars.

Canadian operations, comprising less than 10% of the insurance company's assets or liabilities can be translated to U.S. dollars by making an adjustment to the net assets of the foreign operation. The adjustment is calculated by summarizing the assets and liabilities in the foreign currency and in U.S. dollars. The net value is converted to U.S. dollars at the current rate of exchange and compared with the net value in U.S. dollars recorded by the company. Any difference in the net value to current exchange rates is recorded as a separate asset or liability and the change in the foreign exchange adjustment is recorded as an unrealized capital gain or loss.

All other foreign operations must be translated to U.S. dollars in accordance with the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standard (FAS) No. 52, Foreign Currency Translation. FAS 52 requires each financial statement line to be translated to U.S. dollars by applying the following exchange rates: I) the current exchange rate at the balance sheet date to assets and liabilities and 2) a weighted average rate to revenue, expenses, gains, losses and surplus adjustments. The weighted-average rate is aimed at approximating the translation that would have been achieved had the current rate at the time of each translation been applied. Gains or losses due to translating foreign operations to U.S. dollars should be recorded as an unrealized capital gain or loss.

Source for language of Attachment B: Foreign Exchange Adjustment. Chapter 8, Phase II of Life and Health Accounting Manual Codification Project
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 13 and 25
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 8
- Purposes and Procedures of the Securities Valuation Office of the NAIC, Section 1

Generally Accepted Accounting Principles
- FASB Statement No. 52, Foreign Currency Translation
- FASB Emerging Issues Task Force No. 87-12, Foreign Debt-for-Equity Swaps
- FASB Emerging Issues Task Force No. 87-26, Hedging of Foreign Currency Exposure with a Tandem Currency
- FASB Emerging Issues Task Force No. 92-4, Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary
- FASB Emerging Issues Task Force No. 95-2, Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party
- FASB Emerging Issues Task Force No. 96-15, Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities
- FASB Interpretation No. 37, Accounting for Translation Adjustments upon Sale of Part of an Investment in a Foreign Entity, an interpretation of FASB Statement No. 52
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 12

State Regulations
None

Other Sources of Information
- The Invested Assets Working Group of the Valuation of Securities (EX4) Task Force draft guidance to the Blanks Task Force
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 8
Statutory Issue Paper No. 82

Stock Options and Stock Purchase Plans

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the NAIC Annual Statement Instructions. However, specific guidance regarding the accounting for such plans is not currently provided.

2. GAAP addresses the accounting for stock issued to employees in Accounting Principles Board Opinion No. 25, _Accounting for Stock Issued to Employees_ (APB 25), Accounting Research Bulletin No. 43, _Restatement and Revision of Accounting Research Bulletins_ (ARB 43), Accounting Interpretation of Accounting Principles Board Opinion No. 25, _Accounting for Stock Issued to Employees_ (AIN-APB 25), FASB Interpretation No. 28, _Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans_ (FIN 28), FASB Interpretation No. 38, _Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock_ (FIN 38) and FASB Statement No. 123, _Accounting for Stock-Based Compensation_ (FAS 123).

3. This purpose of this issue paper is to establish statutory accounting principles for employee stock options and stock purchase plans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A plan is any arrangement to issue stock to officers and employees, as a group or individually. Stock purchase and stock option plans shall be classified as either compensatory or noncompensatory. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. Stock purchase and stock option plans which do not meet the criteria of a noncompensatory plan shall be classified as compensatory. A reporting entity recognizes compensation cost for stock issued through compensatory plans.

Noncompensatory Plans

5. The following four characteristics are essential in a noncompensatory plan:

   a. substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded);

   b. stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan);

   c. the time permitted for exercise of an option or purchase right is limited to a reasonable period; and

   d. the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others.
Compensatory Plans

6. Consideration that a reporting entity receives for stock issued through employee stock option, purchase, and award plans in the form of services shall be measured by the fair value of the stock at the measurement date less the amount, if any, that the employee is required to pay.

7. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

8. Compensation cost in stock option, purchase, and award plans shall be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards. An employee may perform services in several periods before a reporting entity issues stock for those services. The reporting entity shall accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, a reporting entity shall record the compensation expense each period from date of grant or award to date of measurement based on the fair value of the stock at the end of each period.

9. Quoted market prices in active markets are the best evidence of fair value and are to be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.

10. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and shall be reported as a component of unassigned funds. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

Accounting for Income Tax Benefits

11. A reporting entity may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. Generally, the reporting entity is entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, the amount and timing of the deduction for income tax purposes, if any, may differ from the related compensation expense recognized in the financial statements. For example, the reporting entity may be entitled to a deduction for income tax purposes even though no compensation expense is recognized in measuring net income.

12. The income tax reduction, if any, related to a stock option, purchase, or award plan shall be accounted for within one or more of the following three components:

a. Income tax expense for a period shall be reduced by no more than the income tax reduction related to the stock option, purchase, or award plan that is proportionate to compensation expense recognized during the period, for such plan.

b. Compensation expense that is deductible in the income tax return for a period different from the one in which such expense is reported in measuring net income results in a temporary difference. Deferred income taxes shall be recognized for such differences and
The remainder of the income tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the income tax reduction shall not be included in income, but shall be added to capital stock or gross paid-in and contributed surplus in the period of the income tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the reporting entity may deduct the difference from capital stock or gross paid-in and contributed surplus in the period of the income tax reduction, to the extent that income tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in capital stock or gross paid-in and contributed surplus.

13. In certain situations, it may be advantageous to the reporting entity to compensate an employee to make an option that is detrimental to him but advantageous to the company. A reporting entity may, either by cash payment or otherwise reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the reporting entity; for example, in incentive stock purchase plans a reduction in the purchase price of stock is allowed. The reporting entity shall include any such reimbursement as an expense.

14. Stock option, purchase, and award plans of the principal stockholder (i.e., a holding company) or equity instruments granted or otherwise transferred directly to an employee by a principal stockholder shall be treated as contributed surplus by the principal stockholder with the offsetting charge accounted for in accordance with this issue paper, unless such transfers are clearly for a purpose other than compensation for services rendered the reporting entity.

15. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

Disclosure
16. The notes to financial statements shall disclose deferred stock compensation plans for employees such as profit sharing, stock options or incentive plans. If warranted by materiality, the following information with regard to stock options shall be furnished and analogous information shall be supplied for warrants or rights:

a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options;

b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories;

c. The required information may be summarized as appropriate with respect to each of these categories. The above information shall be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated
corporation. The information shall be shown separately for (1) agents and brokers and (2) employees and others.

DISCUSSION

17. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the Annual Statement Instructions. This issue paper is consistent with such guidance. This issue paper expands current statutory guidance to provide specific guidance regarding the accounting for such plans. Issue Paper No. 78 - Employee Stock Ownership Plans (Issue Paper No. 78) addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

18. This issue paper rejects FAS 123. FAS 123 encourages, but does not require, that companies report stock based compensation plans using a fair value method of accounting versus the intrinsic value method of accounting promulgated in APB 25. The differences between these two methods of accounting primarily affect the accounting related to stock option plans. Under the intrinsic value method of accounting, the compensation cost of such plans is measured by the excess, if any, of the market price of the underlying stock versus the exercise price of the option at the measurement date. The fair value method of accounting requires that a fair value be determined for the options, generally by utilization of option-pricing models or other valuation techniques, and that the fair value be charged to compensation cost with a corresponding credit to paid in capital. The fair value method of accounting for these plans is rejected because it does not reflect a change in statutory assets or liabilities. Consistent with rejection of FAS 123, the disclosure requirements in the conclusion above retain the current statutory requirements.

19. This issue paper adopts GAAP guidance set forth in APB 25 except for paragraph 19 regarding disclosure. The disclosure required by this issue paper is consistent with the disclosure requirements of ARB 43, Chapter 13B, prior to its amendment by FAS 123. This issue paper adopts GAAP guidance set forth in ARB 43 with modification to exclude the additions to paragraph 2 and the deletion of paragraph 15 pursuant to FAS 123. This issue paper also adopts the GAAP guidance set forth in AIN-APB 25. This issue paper also adopts the GAAP guidance set forth in FIN 28 and FIN 38.

20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstances (such pronouncements are not reproduced herein due to length and limited scope):

FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout
FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding
FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations: Settlement of Stock Options and Awards
FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans
FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans
FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline
FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering
FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option
FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring
FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options
FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25
This issue paper rejects the following pronouncements:

FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123

FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issued For Consideration Other Than Employee Services Under FASB Statement No. 123

21. The conclusions above are consistent with the consistency and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Consistency

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

Recognition

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

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

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

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

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

Drafting Notes/Comments

- Issue Paper No. 78 - Employee Stock Ownership Plans addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
22. The Life Annual Statement Instructions provide the following guidance (only the pertinent excerpts are included below):

6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans
   b. Deferred Compensation Plans
      1. Indicate if the company has deferred compensation plans for officers or employees such as profit sharing, stock options or incentive plans.
      2. If warranted by materiality, the following information with regard to stock options should be furnished and analogous information should be supplied for warrants or rights:
         a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options.
         b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories.

The Property and Casualty Annual Statement Instructions contain similar guidance.

Generally Accepted Accounting Principles
23. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

Chapter 13: COMPENSATION:

Section B -- Compensation Involved in Stock Option and Stock Purchase Plans

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a
measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.¹

¹ Bulletin 37, “Accounting for Compensation in the Form of Stock Options,” was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.

2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also. FASB Statement No. 123, Accounting for Stock-Based Compensation, specifies a fair value based method of accounting for stock-based compensation plans and encourages entities to adopt that method for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. However, Statement 123 permits an employer in determining its net income to continue to apply the accounting provisions of this section and Opinion 25 to all its stock-based employee compensation arrangements. Entities that continue to apply this section and Opinion 25 shall comply with the disclosure requirements of Statement 123.

Rights Involving Compensation

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

Rights Not Involving Compensation

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.
5. Stock purchase plans also are frequently an integral part of a corporation’s program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

Other Considerations

14. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

24. APB 25, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

1. Many corporations have adopted various plans, contracts, and agreements to compensate officers and other employees by issuing to them stock of the employer corporation. Under traditional stock option and stock purchase plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price, often at a discount from the market price of the stock at the date the rights are granted. Stock options and purchase rights are normally granted for future services of employees. Accounting Research Bulletin No. 43, Chapter 13B, Compensation Involved in Stock Option and Stock Purchase Plans (1953), contains the principles of accounting for those plans (reproduced in Appendix B).

2. Among traditional plans not described in Chapter 13B of ARB No. 43 are plans in which an employer corporation awards to employees shares of stock of the corporation for current or future services. Some corporations have replaced or supplemented traditional plans with more complex plans, contracts, and agreements for issuing stock. An arrangement may be based on variable factors that depend on future events; for example, a corporation may award a variable number of shares of stock or may grant a stock option with a variable option price. Other arrangements combine the characteristics of two or more types of plans, and some give an employee an election.

3. Accounting for employee services received as consideration for stock issued is included in an accounting research study¹ on stockholders’ equity that is in process.

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¹ Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

4. This Opinion deals with some aspects of accounting for stock issued to employees through both noncompensatory and compensatory plans (a plan is any arrangement to issue stock to officers and employees, as a group or individually). ARB No. 43, Chapter 13B remains in effect for traditional stock option and stock purchase plans except that the measure of compensation is redefined in this Opinion. This Opinion recognizes certain practices that evolved after Chapter 13B of ARB No. 43 was adopted and applies the principles of that chapter to other plans in which the number of shares of stock that may be acquired by or awarded to an employee and the option or purchase price, if any, are known or determinable at the date of grant or award. It also specifies the accounting for (a) plans in which either the number of shares of stock or the option or purchase price depends on future events and (b) income tax benefits related to stock...
issued to employees through stock option, purchase, and award plans. Appendix A to the Opinion illustrates measuring and accounting for compensation under typical plans.

Differing Views

5. Some accountants believe that compensation cost for all compensatory plans should be recorded at the date of grant or not later than the date of exercise. They believe that past experience and outside evidence of values can overcome difficulties in measuring compensation. Other accountants believe that compensation need not be recorded if an employee pays an amount that is at least equal to the market price of the stock at the date of grant and that problems in accounting for compensation plans pertain to plans in which the number of shares of stock or the option or purchase price cannot be determined until after the date of grant or award. Still other accountants, although they agree in principle with the first group, believe that progress will result from specifying the accounting for plans with variable factors but leaving Chapter 13B of ARB No. 43 in effect with modifications while the entire topic of accounting for compensation involving stock is studied.

6. Some accountants believe that a tax benefit attributable to compensation that is deductible in computing taxable income but is not recorded as an expense of any period results from a permanent difference. The benefit should therefore be recorded under paragraphs 33 and 34 of APB Opinion No 11, Accounting for Income Taxes, as a reduction of income tax expense for the period that the benefit is received. Other accountants believe that the tax benefit results from issuing stock and should be accounted for as an adjustment of capital in addition to par or stated value of capital stock in accordance with paragraph 52 of APB Opinion No. 11.

OPINION

Noncompensatory Plans

7. Paragraphs 4 and 5 of Chapter 13B of ARB No. 43 describe stock option and stock purchase plans that may not be intended primarily to compensate employees. An employer corporation recognizes no compensation for services in computing consideration received for stock that is issued through noncompensatory plans. The Board concludes that at least four characteristics are essential in a noncompensatory plan: (a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others. An example of a noncompensatory plan is the “statutory” employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code.

Compensatory Plans

8. Plans that do not possess the four characteristics of noncompensatory plans are classified as compensatory plans. Since the major principles of Chapter 13B of ARB No. 43 are not changed, classification as a compensatory plan does not necessarily require that compensation cost be recognized.2

2 All compensation arrangements involving stock, regardless of the name given, should be accounted for according to their substance. For example, an arrangement in which the consideration for stock issued to an employee is a nonrecourse note secured by the stock issued may be in substance the same as the grant of a stock option and should be accounted for accordingly. The note should be classified as a reduction of stockholders’ equity rather than as an asset.
9. Services as Consideration for Stock Issued. The consideration that a corporation receives for stock issued through a stock option, purchase, or award plan consists of cash or other assets, if any, plus services received from the employee.

10. Measuring Compensation for Services. Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. That is the principle in Chapter 13B of ARB No. 43 with two modifications: (a) the meaning of fair value of stock for compensatory plans is narrowed and (b) the measurement date for plans with a variable number of shares of stock or a variable option or purchase price is different.

   a. Quoted market price is substituted for fair value. The Board acknowledges the conclusion in Chapter 13B that "market quotations at a given date are not necessarily conclusive evidence" of fair value of shares of stock but concludes that, for purposes of this Opinion, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. An employee's right to acquire or receive shares of stock is presumed to have a value and that value stems basically from the value of the stock to be received under the right. However, the value of the right is also affected by various other factors, some of which tend to diminish its value and some of which tend to enhance it. Those opposing factors include a known future purchase price (or no payment), restrictions on the employee's right to receive stock, absence of commissions on acquisition, different risks as compared with those of a stockholder, tax consequences to the employee, and restrictions on the employee's ability to transfer stock issued under the right. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost related to issuing both restricted (or letter) and unrestricted stock through stock option, purchase, or award plans. If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation.

   b. The measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from Chapter 13B of ARB No. 43. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

Thus a corporation recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

11. Applying the measurement principle--The following supplements paragraph 10 for special situations in some plans.

   a. Measuring compensation by the cost to an employer corporation of reacquired (treasury) stock that is distributed through a stock option, purchase, or award plan is not acceptable practice. The only exception is that compensation cost under a plan with all the provisions described in paragraph 11(c) may be measured by the cost of stock that the corporation (1) reacquires during the fiscal period for which the stock is to be awarded and (2) awards shortly thereafter to employees for services during that period.
b. The measurement date is not changed from the grant or award date to a later date solely by provisions that termination of employment reduces the number of shares of stock that may be issued to an employee.

c. The measurement date of an award of stock for current service may be the end of the fiscal period, which is normally the effective date of the award, instead of the date that the award to an employee is determined if (1) the award is provided for by the terms of an established formal plan, (2) the plan designates the factors that determine the total dollar amount of awards to employees for the period (for example, a percent of income), although the total amount or the individual awards may not be known at the end of the period, and (3) the award pertains to current service of the employee for the period.

d. Renewing a stock option or purchase right or extending its period establishes a new measurement date as if the right were newly granted.

e. Transferring stock or assets to a trustee, agent, or other third party for distribution of stock to employees under the terms of an option, purchase, or award plan does not change the measurement date from a later date to the date of transfer unless the terms of the transfer provide that the stock (1) will not revert to the corporation, (2) will not be granted or awarded later to the same employee on terms different from or for services other than those specified in the original grant or award, and (3) will not be granted or awarded later to another employee.

f. The measurement date for a grant or award of convertible stock or (stock that is otherwise exchangeable for other securities of the corporation) is the date on which the ratio of conversion (or exchange) is known unless other terms are variable at that date (paragraph 10b). The higher of the quoted market price at the measurement date of (1) the convertible stock granted or awarded or (2) the securities into which the original grant or award is convertible should be used to measure compensation.

g. Cash paid to an employee to settle an earlier award of stock or to settle a grant of option to the employee should measure compensation cost. If the cash payment differs from the earlier measure of the award of stock or grant of option, compensation cost should be adjusted (paragraph 15). The amount that a corporation pays to an employee to purchase stock previously issued to the employee through a compensation plan is “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” if stock is reacquired shortly after issuance. Cash proceeds that a corporation receives from sale of awarded stock or stock issued on exercise of an option and remits to the taxing authorities to cover required withholding of income taxes on an award is not “cash paid to an employee to settle an earlier award of stock or to settle a grant of option” in measuring compensation cost.

h. Some plans are a combination of two or more types of plans. An employer corporation may need to measure compensation for the separate parts. Compensation cost for a combination plan permitting an employee to elect one part should be measured according to the terms that an employee is most likely to elect based on the facts available each period.

12. Accruing Compensation Cost. Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the
past pattern of grants or awards (ARB No. 43, Chapter 13B, paragraph 14; APB Opinion No. 12, Omnibus Opinion--1967, paragraph 6).

13. An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.

14. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and should be shown as a separate reduction of stockholders' equity. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

3 State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

15. Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (APB Opinion No. 20, Accounting Changes, paragraphs 31 to 33. For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

16. Accounting for Income Tax Benefits. An employer corporation may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. A corporation is usually entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, a deduction for income tax purposes may differ from the related compensation expense that the corporation recognizes, and the deduction may be allowable in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

4 A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expenses in measuring net income.

17. An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. Compensation expenses that are deductible in a tax return in a period different from the one in which they are reported as expenses in measuring net income result in temporary differences, and deferred taxes should be recorded in accordance with the provisions of FASB Statement No. 109, Accounting for Income Taxes. The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.
18. A corporation may, either by cash payment or otherwise—for example, by allowing a reduction in the purchase price of stock—reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the corporation. The corporation should include the reimbursement in income as an expense.

19. Disclosure. ARB No. 43 Chapter 13B, specifies in paragraph 15 the disclosures related to stock option and stock purchase plans that should be made in financial statements.\(^5\)

\(^5\) Other disclosure requirements are in Regulation S-X for financial statements filed with the Securities and Exchange Commission and in listing agreements of the stock exchanges for financial statements included in annual reports to stockholders.

25. AIN-APB 25 provides the following guidance (only the pertinent excerpts are included below):

1. **STOCK PLANS ESTABLISHED BY A PRINCIPAL STOCKHOLDER**

   Question—Accounting for compensatory and noncompensatory stock option, purchase and award plans adopted by a corporation is discussed in APB Opinion No. 25 and ARB No. 43, Chapter 13B. Should a corporation account for plans or transactions (“plans”), if they have characteristics otherwise similar to compensatory plans adopted by corporations, that are established or financed by a principal stockholder (i.e., one who either owns 10% or more of the corporation's common stock or has the ability, directly or indirectly, to control or influence significantly the corporation)?

   Interpretation—It is difficult to evaluate a principal stockholder's intent when he establishes or finances a plan with characteristics otherwise similar to compensatory plans generally adopted by corporations. A principal stockholder may be satisfying his generous nature, settling a moral obligation, or attempting to increase or maintain the value of his own investment. If a principal stockholder's intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder's personal satisfaction from the benefit to the corporation. Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, paragraph 127 states that “Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.”

   The economic substance of this type of plan is substantially the same for the corporation and the employee, whether the plan is adopted by the corporation or a principal stockholder. Consequently, the corporation should account for this type of plan when one is established or financed by a principal stockholder unless (1) the relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i.e., an immediate family relationship), (2) the stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation), or (3) the corporation clearly does not benefit from the transaction (e.g., the stockholder transfers shares to a minor employee with whom he has had a close relationship over a number of years).

   This type of plan should be treated as a contribution to capital by the principal stockholder with the offsetting charge accounted for in the same manner as compensatory plans adopted by corporations.
Compensation cost should be recognized as an expense of one or more periods in accordance with the provisions of APB Opinion No. 25, paragraphs 12 through 15.

The corporation should account for tax benefits, if any, from this type of plan in accordance with the provisions of APB Opinion No. 25, paragraphs 16 through 18. If the corporation receives no tax benefit from this type of plan, but would have received such benefit had the plan been adopted by the corporation, the absence of such tax benefit is one of the variables in estimating the plan's cost to the corporation (see APB Opinion No. 16, paragraph 89).

26. FIN 28, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

FIN 28 Summary

This Interpretation clarifies aspects of accounting for compensation related to stock appreciation rights and other variable stock option or award plans. The Interpretation specifies that compensation should be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

INTRODUCTION

1. The FASB has been asked to clarify whether the provisions of APB Opinion No. 25, “Accounting for Stock Issued to Employees,” apply to stock appreciation rights and other variable stock option or award plans. Similar questions have been raised about awards under other stock compensation plans with variable terms, that is, plans for which the number of shares of stock the employee may receive, the price per share the employee must pay, or both the number of shares and the price are unknown at the date of grant or award. Appendix A provides additional background information about these matters. Appendix B illustrates applications of this Interpretation.

INTERPRETATION

2. APB Opinion No. 25 applies to plans for which the employer's stock is issued as compensation or the amount of cash paid as compensation is determined by reference to the market price of the stock or to changes in its market price. Plans involving stock appreciation rights and other variable plan awards are included in those plans dealt with by Opinion No. 25. When stock appreciation rights or other variable plan awards are granted, an enterprise shall measure compensation as the amount by which the quoted market value of the shares of the enterprise's stock covered by the grant exceeds the option price or value specified, by reference to a market price or otherwise, subject to any appreciation limitations under the plan. Changes, either increases or decreases, in the quoted market value of those shares between the date of grant and the measurement date result in a change in the measure of compensation for the right or award.

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1 Plans for which the number of shares of stock that may be acquired by or awarded to an employee or the price or both are not specified or determinable until after the date of grant or award are referred to in this Interpretation as “variable plan awards.” However, plans described in paragraph 11(c) of Opinion No. 25 (see paragraph 12 in Appendix A of this Interpretation) and book value stock option, purchase, or award plans are not covered by this Interpretation. Plans under which an employee may receive cash in lieu of stock or additional cash upon the exercise of a stock option are variable plans for purposes of this Interpretation if the amount is contingent on the occurrence of future events.
Paragraph 10 of Opinion No. 25 defines the measurement date as “the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any.” Generally, the number of shares of stock that may be acquired or awarded under stock appreciation rights and many other variable plan awards are not known until the date that they are exercised.

3. Compensation determined in accordance with paragraph 2 shall be accrued as a charge to expense over the period or periods the employee performs the related services (hereinafter referred to as the “service period”). If the stock appreciation rights or other variable plan awards are granted for past services, compensation shall be accrued as a charge to expense of the period in which the rights or awards are granted. If the service period is not defined in the plan or some other agreement, such as an employment agreement, as a shorter or previous period, the service period shall be presumed to be the vesting period.3

3 For purposes of this Interpretation, stock appreciation rights and other variable plan awards become vested when the employee’s right to receive or retain shares or cash under the rights or awards is not contingent upon the performance of additional services. Frequently, the vesting period is the period from the date of grant to the date the rights or awards become exercisable.

4. Compensation accrued during the service period in accordance with paragraph 3 shall be adjusted in subsequent periods up to the measurement date4 for changes, either increases or decreases, in the quoted market value of the shares of the enterprise’s stock covered by the grant but shall not be adjusted below zero. The offsetting adjustment shall be made to compensation expense of the period in which changes in the market value occur. Except as provided in paragraph 5, the accrued compensation for a right that is forfeited or canceled shall be adjusted by decreasing compensation expense in the period of forfeiture, in accordance with paragraph 15 of APB Opinion No. 25.

4 See footnote 2.

5. For purposes of applying paragraph 11(h)5 of APB Opinion No. 25, compensation expense for a combination plan6 involving stock appreciation rights or other variable plan awards (including those that are granted after the date of grant of related stock options) shall be measured according to the terms the employee is most likely to elect based on the facts available each period. An enterprise shall presume that the employee will elect to exercise the stock appreciation rights or other variable plan awards, but the presumption may be overcome if past experience or the terms of a combination plan that limit the market appreciation available to the employee in the stock appreciation rights or other variable plan awards provide evidence that the employee will elect to exercise the related stock option. If an enterprise has been accruing compensation for a stock appreciation right or other variable plan award and a change in circumstances provides evidence that the employee will likely elect to exercise the related stock option, accrued compensation recorded for the right or award shall not be adjusted.7 If the employee elects to exercise the stock option, the accrued compensation recorded for the right or award shall be recognized as a consideration for the stock issued. If all parts of the grant or award (e.g., both the option and the right or award) are forfeited or canceled, accrued compensation shall be adjusted by decreasing compensation expense in that period.

5 See paragraph 13 in Appendix A of this Interpretation.

6 See paragraph 10 in Appendix A of this Interpretation.
A change in the circumstances may be indicated by market appreciation in excess of any appreciation limitations under the plan or the cancellation or forfeiture of the stock appreciation right or other variable plan award without a concurrent cancellation or forfeiture of the related stock option. A subsequent decrease in market value that reduces the appreciation to a level below the limitations under the plan would require adjustment of accrued compensation in accordance with paragraph 4 of this Interpretation if evidence then indicates that the employee will elect to exercise the stock appreciation right or other variable plan award.

FIN 38 Summary

APB Opinion No. 25, Accounting for Stock Issued to Employees, specifies that the measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. Opinion 25 also specifies that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known unless other terms are variable at that date. Questions have been raised about determining the measurement date for stock option, purchase, and award plans involving junior stock, a separate class of stock issued to certain employees that is subordinate to an employer's regular common stock but is convertible into common stock if specified future events occur. This Interpretation clarifies that the measurement date for grants under stock option, purchase, and award plans involving junior stock is the date on which the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock is known. This Interpretation is effective for grants made to employees on or after March 14, 1984 under stock option, purchase, and award plans involving junior stock.

INTRODUCTION

1. The Board has been asked to clarify certain provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, relating to determining the measurement date for grants made to employees under stock option, purchase, and award plans involving junior stock. As used in this Interpretation, the term junior stock refers to a specific type of stock issued to employees that generally is subordinate to an employer's regular common stock with respect to voting, liquidation, and dividend rights and is convertible into regular common stock if certain performance goals are achieved or if certain transactions occur. Junior stock generally is not transferable, except back to the issuing enterprise, and has a fair value lower than regular common stock because of its subordinate rights and the uncertainty of conversion to regular common stock.

1 Junior stock that is not convertible per se but that has restrictions that lapse (such as restrictions that lapse when certain performance goals are achieved) so that it ultimately becomes regular common stock is considered to be convertible for purposes of applying this Interpretation.

2. Stock option, purchase, and award plans involving junior stock are designed to provide that an employer ultimately will issue shares of regular common stock to employees. Those plans are variable plans because the number of shares of regular common stock that an individual employee is entitled to receive is not known until certain performance goals are achieved or certain transactions occur. Therefore, for purposes of measuring compensation cost under Opinion 25, the measurement date for grants under stock option, purchase, and award plans involving junior stock is the first date on which are known both the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock and the option or purchase price, if any.
2 The term variable plan, as used in this Interpretation, is defined in paragraph 14.

3. In considering the convertible features of junior stock, paragraph 11(f) of Opinion 25 indicates that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known, unless other terms are variable at that date. Because conversion of junior stock to regular common stock generally is contingent on achieving certain performance goals or on certain transactions occurring, the conversion ratio is not known with certainty until those future events occur. After those goals are achieved or those transactions occur, the conversion ratio is determinable and, accordingly, the number of shares of regular common stock that an individual is entitled to receive is known.

3 If junior stock becomes convertible only to an equal number of shares of regular common stock upon achieving certain performance goals, the conversion ratio is either one-to-zero or one-to-one; some junior stock plans provide for different ratios of conversion depending on the level of performance attained.

4. Compensation cost for stock option, purchase, and award plans involving junior stock shall be accrued according to the provisions of paragraphs 2-4 of FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, and paragraph 11(g) of Opinion 25. However, the provisions of paragraph 2 of Interpretation 28 shall be applied only when it becomes probable that certain performance goals will be achieved or certain transactions will occur; that probability may or may not be present at the date junior stock is issued.

4 Probable is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that it is likely that certain performance goals will be achieved or certain transactions will occur.

5. Stock option, purchase, and award plans involving junior stock generally are based on certain performance goals being achieved or certain transactions occurring within specific periods. Some plans, however, do not specify a period during which those future events must occur. If it is probable that the future event will occur at some time, compensation cost shall be charged to expense over the period from the date the future event becomes probable to the date the future event is most likely to occur or the end of any required service period. Other plans provide for different ratios of conversion of junior stock to regular common stock within a specific period based on variable performance goals. If achieving more than one performance goal is probable, compensation cost shall be based on the highest ratio of conversion of junior stock to regular common stock attributable to those goals whose achievement is probable. However, the final measure of compensation cost shall be based on the ratio of conversion attributable to the performance goal achieved at the measurement date. For all plans, total compensation shall be based on the market price of the regular common stock as of the date compensation cost is determined.

5 The term service period, as used in this Interpretation, is defined in paragraph 16.

6. Total compensation cost shall be the amount by which the market price at the measurement date of the employer's regular common stock that an employee is entitled to receive exceeds the amount that the employee paid or will pay for the junior stock. If vesting provisions cause junior stock to become convertible to regular common stock after the measurement date, compensation cost shall be recognized during the period from (a) the first
date that it becomes probable that the future events will occur or the date the events have occurred to (b) the date that junior stock becomes convertible or the end of the service period, whichever occurs first. If junior stock does not become convertible to regular common stock but cash is paid to an employee to purchase previously issued junior stock, total compensation cost is the amount by which cash paid to the employee exceeds the amount initially paid by the employee for the junior stock.

28. FAS 123 provides the following guidance (only the pertinent excerpts are included below):

INTRODUCTION

1. This Statement establishes a fair value based method of accounting for stock-based compensation plans. It encourages entities to adopt that method in place of the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees, for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of its stock.

   1 Terms defined in Appendix E, the glossary, are set in boldface type the first time they appear.

2. This Statement also establishes fair value as the measurement basis for transactions in which an entity acquires goods or services from nonemployees in exchange for equity instruments. This Statement uses the term compensation in its broadest sense to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee or not. For example, employee compensation includes both cash salaries or wages and other consideration that may be thought of more as means of attracting, retaining and motivating employees than as direct payment for services rendered.

3. Opinion 25, issued in 1972, requires compensation cost for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Opinion 25 specifies different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award are fixed or variable, as those terms are defined in Opinion 25.

   2 This Statement refers to recognizing compensation cost rather than compensation expense because part of the amount recognized in a period may be capitalized as part of the cost to acquire an asset, such as inventory.

   3 The Statement used the term award as the collective noun for multiple instruments with the same terms granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected lives.

4. Since 1972, stock options and other forms of stock-based employee compensation plans have become increasingly common. Also, option-pricing models have become widely used for measuring the value of stock options and similar equity instruments other than those issued to employees as compensation. Opinion 25 has been criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of stock-based employee compensation plans. Several FASB Interpretations and Technical Bulletins have dealt with specific kinds of plans, and the Emerging Issues Task Force has considered numerous related issues.

5. Because of the perceived deficiencies in Opinion 25, early in the 1980s the AICPA’s Accounting Standards Executive Committee, the staff of the Securities and Exchange Commission, most of the larger accounting firms, industry representatives and others asked the
Stock Options and Stock Purchase Plans  

Board to reconsider the accounting specified in Opinion 25. This Statement, which is the result of that reconsideration, establishes an accounting method based on the fair value of equity instruments awarded to employees as compensation that mitigates many of the deficiencies in Opinion 25. The Board encourages entities to adopt the new method. However, this Statement permits an entity in determining its net income to continue to apply the accounting provisions of Opinion 25 to its stock-based employee compensation arrangements. An entity that continues to apply Opinion 25 must comply with the disclosure requirements of this Statement, which supersedes the disclosure requirements of paragraph 19 of Opinion 25. This Statement also supersedes or amends other accounting pronouncements listed in Appendix D. Appendix A explains the reasons the Board decided not to require recognition of compensation cost for stock-based employee compensation arrangements measured in accordance with the fair value based method described in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope and Alternative Accounting Methods

6. This Statement applies to all transactions in which an entity acquires goods or services by issuing equity instruments or by incurring liabilities to the supplier in amounts based on the price of the entity’s common stock or other equity instruments. Therefore, it applies to all transactions in which an entity grants shares of its common stock, stock options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan.5

4 An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date of for a specified time whether to deliver the consideration for it or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not issued until the issuing entity has received the consideration, such as cash, an enforceable right to receive cash, other financial instruments, goods, or services, agreed to by the parties to the transaction. For that reason, this Statement does not use the term issued for the grant of stock options or other equity instruments subject to service or performance conditions (or both) for vesting.

5 AICPA Statement of Position No. 93-6, Employers’ Accounting for Employee Stock Ownership Plans, specifies the accounting by employers for employee stock ownership plans.

7. The accounting for all stock-based compensation arrangements with employees or others shall reflect the inherent rights and obligations, regardless of how those arrangements are described. For example, the rights and obligations embodied in a transfer to stock to an employee for consideration of a nonrecourse note are substantially the same as if the transaction were structured as the grant of a stock option, and the transaction shall be accounted for as such. The terms of the arrangement may affect the fair value of the stock options or other equity instruments and shall be appropriately reflected in determining that value. For example, whether an employee who is granted an implicit option structured as the exchange of shares of stock for a nonrecourse note is required to pay nonrefundable interest on the note affects the fair value of the implicit option.

Accounting for Transactions with Other Than Employees

8. Except for transactions with employees that are within the scope of Opinion 25, all transactions in which goods or services are the consideration received for the issuance of equity instruments shall be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The fair value of goods or services received from suppliers other than employees frequently is reliably measurable and therefore indicates the fair value of the equity instruments issued. The fair value of the equity instruments issued shall be used to measure the transaction if that value is more reliably measurable than the fair value of the consideration received.6 A common example of the
latter situation is the use of the fair value of tradable equity instruments issued in a purchase business combination to measure the transaction because the value of the equity instruments issued is more reliably measurable than the value of the business acquired.

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6 The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include intangible rights. FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Insured in Defending Against a Takeover Attempt, provides pertinent guidance.

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9. This Statement uses the term *fair value* for assets and financial instruments, including both liability and equity instruments, with the same meaning as in FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Live Assets to be Disposed Of, Statement 121 says that the fair value of an asset is

...the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis [paragraph 7].

10. If the fair value of the goods or services received is not reliably measurable, paragraph 8 of this Statement requires that the measure of the cost of goods or services acquired in a transaction with other than an employee is based on the fair value of the equity instruments issued. However, this Statement does not prescribe the *measurement date*, that is, the date of the stock price on which the fair value of the equity instrument is based, for a transaction with a nonemployee (paragraphs 70-73).

Accounting for Transactions with Employees

11. This Statement provides a choice of accounting methods for transactions with employees that are within the scope of Opinion 25. Paragraphs 16-44 of this Statement describe a method of accounting based on the fair value, rather than the *intrinsic value*, of an employee stock option or a similar equity instrument. The Board encourages entities to adopt the fair value based method of accounting, which is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under APB Opinion No. 20, Accounting Changes.7 However, an entity may continue to apply Opinion 25 in accounting for its stock-based employee compensation arrangements. An entity that does so shall disclose pro forma net income and, if presented, earnings per share, determined as if the fair value based method had been applied in measuring compensation cost (paragraph 45).

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7 Opinion 20, paragraph 8, provides that initial adoption of an accounting principle for a transaction that the entity has not previously had to account for is not a change in accounting principle.

12. The fair value based method described in paragraphs 16-44 of this Statement applies for (a) measuring stock-based employee compensation cost by an entity that adopts that method for accounting purposes and (b) determining the pro forma disclosures required of an entity that measures stock-based employee compensation cost in accordance with the intrinsic value based method in Opinion 25. Neither those paragraphs (16-44) nor subsequent paragraphs (45-54) of
this Statement affect application of the accounting provisions of Opinion 25 by an entity that continues to apply it in determining reported net income.

13. For convenience, in describing the fair value based method, paragraphs 16-44 of this Statement refer only to recognition or accounting requirements. However, those provisions apply equally in determining the pro forma amounts that must be disclosed if an entity continues to apply Opinion 25.

14. An entity shall apply the same accounting method—either the fair value based method described in this Statement or the intrinsic value based method in Opinion 25—in accounting for all of its stock-based employee compensation arrangements. Once an entity adopts the fair value based method for those arrangements, that election shall not be reversed. 8

15. Equity instruments granted or otherwise transferred directly to an employee by a principal stockholder are stock-based employee compensation to be accounted for by the entity under either Opinion 25 or this Statement, whichever method the entity is applying, unless the transfer clearly is for a purpose other than compensation. 9 The substance of a transaction in which a principal stockholder directly transfers equity instruments to an employee as compensation is that the principal stockholder makes a capital contribution to the entity and the entity awards equity instruments to its employee. An example of a situation in which a direct transfer of equity instruments to an employee from a principal stockholder is not compensation cost is a transfer to settle an obligation of the principal stockholder unrelated to employment by the reporting entity.

8 APB Opinion No. 22, Disclosure of Accounting Policies, requires an entity to include a description of all significant accounting policies as an integral part of the financial statements. The method used to account for stock-based employee compensation arrangements is an accounting policy to be included in that description.

9 That accounting has been required since 1973 in accordance with AICPA Accounting Interpretation 1, “Stock Plans Established by a Principal Stockholder,” of Opinion 25.

VALUATION OF EQUITY INSTRUMENTS ISSUED FOR EMPLOYEE SERVICES

Measurement Basis

16. Frequently, part or all of the consideration received for equity instruments issued to employees is past or future employee services. Equity instruments issued to employees and the cost of the services received as consideration shall be measured and recognized based on the fair value of the equity instruments issued. The portion of the fair value of an equity instrument attributed to employee services is net of the amount, if any, that employees pay for the instrument when it is granted. Paragraphs 17-25 of this Statement provide guidance on how to measure the fair value of stock-based employee compensation. Paragraphs 26-33 provide guidance on how to attribute compensation cost to the periods in which employees render the related services. Appendix B, which is an integral part of this Statement, provides additional guidance on both measurement and attribution of employee compensation cost.

Measurement Objective and Date

17. The objective of the measurement process is to estimate the fair value, based on the stock price at the grant date, of stock options or other equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise stock options or to sell shares of stock). Restrictions that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer vested employee stock options to third parties, affect the value of the instruments actually issued and therefore are reflected in estimating their fair value. However, restrictions that stem directly from the
forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested option or to sell nonvested stock, do not affect the value of the instruments issued at the vesting date, and their effect therefore is not included in that value. Instead, no value is attributed to instruments that employees forfeit because they fail to satisfy specified service- or performance-related conditions.

Measurement Methods

Awards That Call for Settlement by Issuing Equity Instruments

18. The fair value of a share of nonvested stock awarded to an employee shall be measured at the market price (or estimated market price, if the stock is not publicly traded) of a share of the same stock as if it were vested and issued on the grant date. Nonvested stock granted to employees usually is referred to as restricted stock, but this Statement reserves that term for shares whose sale is contractually or governmentally restricted after the shares are vested and fully outstanding. The fair value of a share of restricted stock awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount as a share of similarly restricted stock issued to nonemployees.

19. The fair value of a stock option (or its equivalent) granted by a public entity shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock (except as provided in paragraphs 32 and 33), and the risk-free interest rate for the expected term of the option. For options that a U.S. entity grants on its own stock, the risk-free interest rate used shall be the rate currently available on zero-coupon U.S. government issues with a remaining term equal to the expected life of the options. Guidance on selecting other assumptions is provided in Appendix B. The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock or the risk-free interest rate.

20. A nonpublic entity shall estimate the value of its options based on the factors described in the preceding paragraph, except that a nonpublic entity need not consider the expected volatility of its stock over the expected life of the option. The result of excluding volatility in estimating an option’s value is an amount commonly termed minimum value.

21. It should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted. Appendix B illustrates techniques for estimating the fair values of several options with complicated features. However, in unusual circumstances, the terms of a stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument’s fair value at the date it is granted. For example, it may be extremely difficult, if not impossible, to reasonably estimate the fair value of a stock option whose exercise price decreases (or increases) by a specified amount with specified changes in the price of the underlying stock. Similarly, it may not be possible to reasonably estimate the value of a convertible instrument if the conversion ratio depends on the outcome of future events.

22. If it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost shall be the fair value based on the stock price and other pertinent factors at the first date at which it is possible to reasonably estimate that value. Generally, that is likely to be the date at which the number of shares to which an employee is entitled and the exercise price are determinable. Estimates of compensation cost for periods during which it is not possible to determine fair value shall be based on the current intrinsic value of the award, determined in accordance with the terms that would apply if the option or similar instrument had been currently exercised.
23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

   a) The plan incorporates no option features other than the following, which may be incorporated:

      (1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.

      (2) The purchase price is based solely on the stock’s market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).

   b) The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.

   c) Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock’s market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the stock’s market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

Awards That Call for Settlement in Cash

25. Some awards of stock-based compensation result in the entity’s incurring a liability because employees can compel the entity to settle the award by transferring its cash or other assets to employees rather than by issuing equity instruments. For example, an entity may incur a liability to pay an employee either on demand or at a specified date an amount to be determined by the increase in the entity’s stock price from a specified level. The amount of the liability for such an award shall be measured each period based on the current stock price. The effects of change in the stock price during the service period are recognized as compensation cost over the service period in accordance with the method illustrated in FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Changes in the amount of the liability due to stock price changes after the service period are compensation cost of the period in which the changes occur.

Recognition of Compensation Cost

26. The total amount of compensation cost recognized for an award of stock-based employee compensation shall be based on the number of instruments that eventually vest. No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a fixed award, or because the entity does not achieve a performance condition, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached. Previously recognized compensation cost shall not be reversed if a vested employee stock option expires unexercised.
10 The existence of a target stock price that must be achieved to make an option exercisable generally affect the value of the option. Option-pricing models have been adapted to value many of those path-dependent options.

27. For purposes of this Statement, a stock-based employee compensation award becomes vested when an employee’s right to receive or retain shares of stock or cash under the award is not contingent on the performance of additional services. Typically, an employee stock option that is vested also is immediately exercisable. However, if performance conditions affect either the exercise price or the exercisability date, the service period used for attribution purposes shall be consistent with the assumptions used in estimating the fair value of the award. Paragraphs 209 and 310 in Appendix B illustrate how to account for an option whose exercise price depends on a performance condition.

28. An entity may choose at the grant date to base accruals of compensation cost on the best available estimate of the number of options or other equity instruments that are expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from initial estimates. Alternatively an entity may begin accruing compensation cost as if all instruments granted that are subject only to a service requirement are expected to vest. The effect of actual forfeitures would then be recognized as they occur. Initial accruals of compensation cost for an award with a performance condition that will determine the number of options or shares to which all employees receiving the award will be entitled shall be based on the best estimate of the outcome of the performance condition, although forfeitures by individual employees may either be estimated at the grant date or recognized only as they occur.11

11 For convenience, the remainder of this document refers to options or shares expected to vest because referring specifically to both acceptable methods of accounting for forfeitures by individual employees each time the point is mentioned would be too unwieldy.

29. Compensation cost estimated at the grant date for the number of instruments that are expected to vest based on performance-related conditions, as well as those in which vesting is contingent only on future service for which the entity chooses to estimate forfeitures at the grant date pursuant to paragraph 28, shall be adjusted for subsequent changes in the expected or actual outcome of service- and performance-related conditions until the vesting date. The effect of a change in the estimated number of shares or options expected to vest is a change in an estimate, and the cumulative effect of the change on current and prior periods shall be recognized in the period of the change.

30. The compensation cost for an award of equity instruments to employees shall be recognized over the period(s) in which the related employee services are rendered by a charge to compensation cost and a corresponding credit to equity (paid-in capital) if the award is for future service. If the service period is not defined as an earlier or shorter period, the service period shall be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service (paragraph 27). If an award is for past services, the related compensation cost shall be recognized in the period in which it is granted.

31. Compensation cost for an award with a graded vesting schedule shall be recognized in accordance with the method described in Interpretation 28 if the fair value of the award is determined based on different expected lives for the options that vest each year, as it would be if the award is viewed as several separate awards, each with a different vesting date. If the expected life or lives of the award is determined in another manner, the related compensation cost may be recognized on a straight-line basis. However, the amount of compensation cost
recognized at any date must at least equal the value of the vested portion of the award at that date. Appendix B illustrates application of both attribution methods to an award accounted for by the fair value based method.

32. Dividends or dividend equivalents paid to employees on the portion of an award of stock or other equity instruments that vests shall be charged to retained earnings. Nonforfeitable dividends or dividend equivalents paid on shares of stock that do not vest shall be recognized as additional compensation cost. The choice of whether to estimate forfeitures at the grant date or to recognize the effect of forfeitures as they occur described in paragraph 28 also applies to recognition of nonforfeitable dividends paid on shares that do not vest.

33. If employees received only the dividends declared on the class of stock granted to them after the stock becomes vested, that value of the award at the grant date shall be reduced by the present value of dividends expected to be paid on the stock during the vesting period, discounted at the appropriate risk-free interest rate. The fair value of an award of stock options on which dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant to antidilution provisions shall be estimated based on a dividend payment of zero.

Additional Awards and Modifications of Outstanding Awards

34. The fair value of each award of equity instruments, including an award of reload options, shall be measured separately based on its terms and the current stock price and related factors at the date it is granted.

35. A modification of the terms of an award that makes it more valuable shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater value, incurring additional compensation cost for that incremental value. The incremental value shall be measured by the difference between (a) the fair value of the modified option determined in accordance with the provisions of this Statement and (b) the value of the old option immediately before its terms are modified, determined based on the shorter of (1) its remaining expected life or (2) the expected life of the modified option. Appendix B provides further guidance on and illustrates the accounting for modifications of both vested and nonvested options.

36. Exchanges of options or changes to their terms in conjunction with business combinations, spin-offs, or other equity restructurings, except for those made to reflect the terms of the exchange of shares in a business combination accounted for as a pooling of interests, are modifications for purposes of this Statement. However, a change to the terms of an award in accordance with antidilution provisions that are designed, for example, to equalize an option’s value before and after a stock split or a stock dividend is not a modification of an award for purposes of this Statement.

Settlements of Awards

37. An entity occasionally may repurchase equity instruments issued to employees after the employees have vested rights to them. The amount of cash or other assets paid (or liabilities incurred) to repurchase an equity instrument shall be charged to equity, provided that the amount paid does not exceed the value of the instruments repurchased. For example, an entity that repurchases for $10 a share of stock on the date it becomes vested does not incur additional compensation cost if the market price of the stock is $10 at that date. However, if the market price of the stock is only $8 at that date, the entity incurs an additional $2 ($10 - $8) of cost. An entity that settles a nonvested award for cash has, in effect, vested the award, and the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the date of repurchase.

38. For employee stock options, the incremental amount, if any, to be recognized as additional compensation cost upon cash settlement shall be determined based on a comparison of the amount paid with the value of the option repurchased, determined based on the remainder
of its original expected life at that date. As indicated in paragraph 37, if stock options are repurchased before they become vested, the amount of unrecognized compensation cost shall be recognized at the date of the repurchase.

39. The accounting shall reflect the terms of a stock-based compensation plan as those terms are mutually understood by the employer and the employees who receive awards under the plan. Generally, the written plan provides the best evidence of its terms. However, an entity’s past practice may indicate that the substantive terms of a plan differ from its written terms. For example, an entity that grants a tandem award consisting of either a stock option or a cash stock appreciation right (SAR) is obligated to pay cash on demand if the choice is the employee’s, and the entity thus incurs a liability to the employee. In contract, if the choice is the entity’s, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock generally settles in cash, or if the entity generally settles in cash whenever an employee asks for cash settlement, the entity probably is settling a substantive liability rather than repurchasing an equity instrument. The substantive terms shall be the basis for the accounting.

40. To restrict control to a limited group, for example, the members of a particular family, a nonpublic entity may obligate itself to repurchase its equity instruments for their fair value at the date of repurchase. In practice, such an obligation is not deemed to convert the stock to a liability. This Statement is not intended to change that view of the effect of a fair value repurchase agreement for a nonpublic entity. Thus, a nonpublic entity may grant or otherwise issue to employees equity instruments subject to such a repurchase agreement. The repurchase agreement does not convert those equity instruments to liabilities, provided that the repurchase price is the fair value of the stock at the date of repurchase.

Accounting for Tax Consequences of Equity Instruments Awarded to Employees

41. Income tax regulations specify allowable tax deductions for stock-based employee compensation arrangements in determining an entity’s income tax liability. Compensation cost recognized under this Statement is measured based on the fair value of an award to an employee. Under existing U.S. tax law, allowable tax deductions are generally measured at a specified date as the excess of the market price of the related stock over the amount the employee is required to pay for the stock (that is, at intrinsic value). The time value component of the fair value of an option is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

42. The cumulative amount of compensation cost recognized for a stock-based award that ordinarily results in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying FASB Statement No. 109, Accounting for Income Taxes. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, as additional service is rendered and the related cost is recognized, shall be recognized in the income statement. Recognition of compensation cost for an award that ordinarily does not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee’s disqualifying disposition of stock under existing U.S. tax law, can give rise to a tax deduction for an award that ordinarily does not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

43. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity’s stock shall not be considered in measuring either the gross deferred tax asset of the need for a valuation allowance for a deferred tax asset recognized under this Statement.
44. If a deduction reported on a tax return for a stock-based award exceeds that cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction shall be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, shall be recognized in the income statement except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous stock-based employee compensation awards accounted for in accordance with the fair value based method in this Statement. In that situation, the amount of the write-off shall be charged against that additional paid-in capital.

Disclosures

45. Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures specified in paragraphs 46-48. In addition, an entity that continues to apply Opinion 25 shall disclose for each year for which an income statement is provided the pro forma net income and, if earnings per share is presented, pro forma earnings per share, as if the fair value based accounting method in this Statement had been used to account for stock-based compensation cost. Those pro forma amounts shall reflect the difference between compensation cost, if any, included in net income in accordance with Opinion 25 and the related cost measured by the fair value based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. The required pro forma amounts shall reflect no other adjustments to reported net income or earnings per share.

46. An entity with one or more stock-based compensation plans shall provide a description of the plan(s), including the general terms of awards under the plan(s), such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments. An entity that uses equity instruments to acquire goods or services other than employee services shall provide disclosures similar to those required by this paragraph and paragraphs 47 and 48 to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements.

47. The following information shall be disclosed for each year for which an income statement is provided:

a. The number and weighted-average exercise prices of options for each of the following groups of options: (1) those outstanding at the beginning of the year, (2) those outstanding at the end of the year, (3) those exercisable at the end of the year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the year.

b. The weighted-average grant-date fair value of options granted during the year. If the exercise prices of some options differ from the market price of the stock on the grant date, weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price (1) equals, (2) exceeds, or (3) is less than the market price of the stock on the grant date.

c. The number and weighted-average grant-date fair value of equity instruments other than options, for example, shares of nonvested stock, granted during the year.

d. A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information: (1) risk-free interest rate, (2) expected life, (3) expected volatility, and (4) expected dividends.
e. Total compensation cost recognized in income for stock-based employee compensation awards.

f. The terms of significant modifications of outstanding awards.

An entity that grants options under multiple stock-based employee compensation plans shall provide the foregoing information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity’s use of stock-based compensation. For example, separate disclosure of weighted-average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price is likely to be important, as would segregating the number of options not yet exercisable into those that will become exercisable based solely on employees rendering additional service and those for which an additional condition must be met for the options to become exercisable.

48. For options outstanding at the date of the latest statement of financial position presented, the range of exercise prices (as well as the weighted-average exercise price) and the weighted-average remaining contractual life shall be disclosed. If the range of exercise prices is wide (for example, the highest exercise price exceeds approximately 150 percent of the lowest exercise price), the exercise prices shall be segregated into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received as a result of option exercises. The following information shall be disclosed for each range:

   a. The number, weighted-average exercise price, and weighted-average remaining contractual life of options outstanding

   b. The number and weighted-average exercise price of options currently exercisable.

Earnings per Share Implications

49. APB Opinion No. 15, *Earnings per Share*, requires that employee stock options, nonvested stock, and similar equity instruments granted to employees be treated as common stock equivalents in computing earnings per share. The number of nonvested equity instruments used in computing primary earnings per share shall be the same as the number that are used in measuring the related compensation cost in accordance with this Statement. Fully diluted earnings per share shall continue to be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting is contingent on other factors, such as the level of future earnings, the shares or options shall be treated as contingent shares in accordance with paragraph 62 of Opinion 15. AICPA Accounting Interpretation 91, “Earnings Conditions,” of Opinion 15 provides additional guidance on applying paragraph 62 of Opinion 15 to stock-based employee compensation plans. If stock options or other equity instruments are granted during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

50. In applying the treasury stock method of Opinion 15, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay, (b) the amount of compensation cost attributed to future services and not yet recognized, and (c) the Interpretation No. 31, *Treatment of Stock Compensation Plans in EPS Computations*, provides detailed examples of the treatment of stock compensation plans accounted for under Opinion 25 in earnings per share computations. Although the related cost and tax amounts will differ if the fair value based accounting method in this Statement is applied, the principles in Interpretation 31 remain applicable.

Effective Date and Transition

51. The requirement in paragraph 8 of this Statement shall be effective for transactions entered into after December 15, 1995.
52. The recognition provisions of this Statement may be adopted upon issuance. Regardless of when an entity initially adopts those provisions, they shall be applied to all awards granted after the beginning of the fiscal year in which the recognition provisions are first applied. The recognition provisions shall not be applied to awards granted in fiscal years before the year of initial adoption except to the extent that prior years’ awards are modified or settled in cash after the beginning of the fiscal year in which the entity adopts the recognition provisions. Accounting for modifications and settlements of awards initially accounted for in accordance with Opinion 25 is discussed and illustrated in Appendix B.

53. The disclosure requirements of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1995, or for the fiscal year for which this Statement is initially adopted for recognizing compensation cost, whichever comes first. The disclosure requirements need not be applied in an interim report unless a complete set of financial statements is presented for that period. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994 need not be included in financial statements for that fiscal year but shall be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

54. During the initial phase-in period, the effects of applying this Statement for either recognizing compensation cost or providing pro forma disclosures are not likely to be representative of the effects on reported net income for future years, for example, because options vest over several years and additional awards generally are made each year. If that situation exists, the entity shall include a statement to that effect. The entity also may wish to provide supplemental disclosure of the effect of applying the fair value based accounting method to all awards made in fiscal years beginning before the date of initial adoption that were not vested at that date.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 78 - Employee Stock Ownership Plans
- Issue Paper No. 83 - Accounting for Income Taxes

Generally Accepted Accounting Principles
- Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees
- Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 13, Section B,
- Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees
- FASB Statement No. 123, Accounting for Stock-Based Compensation
- FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans
- FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock
- FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout
- FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding
- FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations, Settlement of Stock Options and Awards
- FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans
- FASB Emerging Issues Task Force Issue No. 87-23, *Book Value Stock Purchase Plans*
- FASB Emerging Issues Task Force Issue No. 87-33, *Stock Compensation Issues Related to Market Decline*
- FASB Emerging Issues Task Force Issue No. 88-6, *Book Value Plans in an Initial Public Offering*
- FASB Emerging Issues Task Force Issue No. 90-7, *Accounting for a Reload Stock Option*
- FASB Emerging Issues Task Force Issue No. 90-9, *Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*
- FASB Emerging Issues Task Force Issue No. 94-6, *Accounting for the Buyout of Compensatory Stock Options*
- FASB Emerging Issues Task Force Issue No. 95-16, *Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25*
- FASB Emerging Issues Task Force Issue No. 96-3, *Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123*
- FASB Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments with Variable Terms That Are Issue For Consideration Other Than Employee Services Under FASB Statement No. 123*

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 83

Accounting for Income Taxes

STATUS
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Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting principles, as applied to income taxes, generally only reflect a reporting entity’s incurred current taxes and do not consider the tax effects of differences between statutory accounting income and taxable income. While there have always been differences between statutory accounting income and taxable income, tax law changes since 1984 have resulted in greater differences between the two accounting methods. As a result, statutory surplus does not clearly reflect a reporting entity’s ultimate income tax obligation for transactions recorded in the financial statements.

2. GAAP guidance on accounting for income taxes is provided in FASB Statement No. 109, Accounting for Income Taxes (FAS 109).

3. Current statutory accounting guidance is not specific with respect to:
   a. The definition of incurred taxes as it relates to accounting for tax contingencies and the “true-up” portion of the equity tax of mutual life insurance companies and
   b. The criteria for admissibility of income tax recoverables from the Internal Revenue Service (IRS) and the definition of “settled within a reasonable time” as applied to recoverables from a reporting entity’s parent pursuant to a written income tax allocation agreement.

4. The purpose of this paper is to establish statutory accounting principles for income taxes that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

5. For purposes of statutory accounting, “income taxes incurred” includes current income taxes, the amount of federal and foreign income taxes paid (recovered) or payable (recoverable) for the current year. Current income taxes are defined as:
   a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the “true-up” of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) and
   b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in Issue Paper No. 3 - Accounting Changes (Issue Paper No. 3).

6. Additionally, for purposes of statutory accounting, a reporting entity’s Statement of Assets, Liabilities, Surplus and Other Funds, shall include deferred income tax assets (DTAs) and liabilities.
(DTLs). DTAs and DTLs are the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109. FAS 109 is excerpted in paragraph 50 of this issue paper.

7. A reporting entity’s deferred tax assets and liabilities are computed as follows:
   a. Temporary differences are identified and measured using a “balance sheet” approach whereby statutory and tax basis balance sheets are compared,
   b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that “tax and loss” bonds have been purchased,
   c. Total DTAs and DTLs are computed using enacted tax rates and
   d. Consistent with FAS 109, a DTL is not recognized for amounts described in paragraph 31 of FAS 109.

8. Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus).

9. Gross DTAs shall be admitted in an amount equal to the sum of:
   a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year,
   b. The lesser of:
      i. The amount of gross DTAs, after the application of paragraph 9.a., expected to be realized within one year of the balance sheet date, or
      ii. Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and
   c. The amount of gross DTAs, after the application of paragraphs 9.a. and 9.b., that can be offset against existing DTLs.

10. In computing a reporting entity’s gross DTA pursuant to paragraph 9;
    a. Existing temporary differences that reverse by the end of the subsequent calendar year shall be determined in accordance with paragraphs 228 and 229 of FAS 109;
    b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;
    c. The amount of carryback potential that may be considered in calculating the gross DTAs of a reporting entity in subparagraph 9.a. above, that files a consolidated income tax
return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and

d. The phrases “reverse by the end of the subsequent calendar year” and “realized within one year of the balance sheet date” are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

11. Current income tax recoverables are defined to include all current income taxes, including interest, reasonably expected to be recovered in a subsequent accounting period, whether or not a return or claim has been filed with the taxing authorities. Current income tax recoverables are assets, as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4), and are reasonably expected to be recovered if the refund is attributable to an overpayment of estimated tax payments, an error, a carryback, as defined in paragraph 289 of FAS 109, or an item for which the reporting entity has substantial authority, as defined in paragraph 52 of this issue paper.

12. In the case of a reporting entity that files a consolidated income tax return with one or more affiliates, income tax transactions (including payment of tax contingencies to its parent) between the affiliated parties shall be recognized if:

   a. Such transactions are economic transactions as defined in Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (Issue Paper No. 25),
   
   b. Are pursuant to a written income tax allocation agreement and
   
   c. Income taxes incurred are accounted for in a manner consistent with the principles of FAS 109, as modified by this issue paper.

Amounts owed to a reporting entity pursuant to a recognized transaction shall be treated as a loan or advance, and nonadmitted, pursuant to Issue Paper No. 25, to the extent that the recoverable is not settled within 90 days of the filing of a consolidated income tax return, or where a refund is due the reporting entity’s parent, within 90 days of the receipt of such refund.

13. Income taxes incurred shall be allocated to net income and realized capital gains or losses in a manner consistent with paragraph 38 of FAS 109. Furthermore, income taxes incurred or received during the current year attributable to prior years shall be allocated, to the extent not previously provided, to net income in accordance with Issue Paper No. 3 unless attributable, in whole or in part, to realized capital gains or losses, in which case, such amounts shall be apportioned between net income and realized capital gains and losses, as appropriate.

14. Income taxes incurred in interim periods shall be computed using an estimated annual effective current tax rate for the annual period in accordance with the methodology described in paragraphs 19 and 20 of Accounting Principles Board Opinion No. 28, Interim Financial Reporting (APB 28). Estimates of the annual effective tax rate at the end of interim periods are, of necessity, based on estimates and are subject to subsequent refinement or revision. If a reliable estimate cannot be made, the actual effective tax rate for the year-to-date may be the best estimate of the annual effective tax rate. If a reporting entity is unable to estimate a part of its “ordinary” income (or loss) or the related tax (or benefit) but is otherwise able to make a reliable estimate, the tax (or benefit) applicable to the item that cannot be estimated shall be reported in the interim period in which the item is reported. APB 28 is excerpted in paragraph 51 of this issue paper.

15. Statutory financial statement disclosure shall be made in a manner consistent with the provisions of paragraphs 43 - 45 and 48 of FAS 109. However, required disclosures with regard to a reporting
entity’s valuation allowance shall be replaced with disclosures relating to the nonadmittance of some portion or all of a reporting entity’s DTAs. Additionally, to the extent that the sum of a reporting entity’s “income taxes incurred” (i.e., current income taxes) and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items. Current statutory financial statement disclosure, as it relates to intercompany tax allocation agreements, is retained. Current statutory financial statement disclosure is excerpted in paragraphs 42 and 43 of this issue paper. Paragraphs 16 to 21 describe the disclosure requirements as modified for the difference between the requirements of FAS 109 and those prescribed by this issue paper.

16. The components of the net DTA or DTL recognized in a reporting entity’s balance sheet shall be disclosed as follows:
   a. The total of all DTAs (admitted and nonadmitted);
   b. The total of all DTLs;
   c. The total DTAs nonadmitted as the result of the application of paragraph 9; and
   d. The net change during the year in the total DTAs nonadmitted.

17. To the extent that DTLs are not recognized for amounts described in paragraph 31 of FAS 109, the following shall be disclosed:
   a. A description of the types of temporary differences for which a DTL has not been recognized and the types of events that would cause those temporary differences to become taxable;
   b. The cumulative amount of each type of temporary difference;
   c. The amount of the unrecognized DTL for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable; and
   d. The amount of the DTL for temporary differences other than those in item c. above that is not recognized in accordance with the provisions of paragraphs 31 of FAS 109.

18. The significant components of income taxes incurred (i.e., current income tax expense) and the changes in DTAs and DTLs shall be disclosed. Those components would include, for example:
   a. Current tax expense or benefit;
   b. The change in DTAs and DTLs (exclusive of the effects of other components listed below);
   c. Investment tax credits;
   d. The benefits of operating loss carryforwards; and
   e. Adjustments of a DTA or DTL for enacted changes in tax laws or rates or a change in the tax status of the reporting entity.
19. Additionally, to the extent that the sum of a reporting entity’s income taxes incurred and the change in its DTAs and DTLs is different from the result obtained by applying the federal statutory rate to its pretax net income, a reporting entity shall disclose the nature of the significant reconciling items.

20. A reporting entity shall also disclose the following:
   
a. The amounts, origination dates and expiration dates of operating loss and tax credit carryforwards available for tax purposes; and

b. The amount of federal income taxes incurred in the current year and each preceding year, which are available for recoupment in the event of future net losses.

21. If a reporting entity’s federal income tax return is consolidated with those of any other entity or entities, the following shall be disclosed:
   
a. A list of names of the entities with whom the reporting entity’s federal income tax return is consolidated for the current year; and

b. The substance of the written agreement, approved by the reporting entity’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Additionally, the disclosure shall include the manner in which the entity has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

DISCUSSION

22. Statutory accounting principles with respect to income taxes incurred (i.e., current income taxes), as set forth in this issue paper, differ from current statutory guidance as follows:
   
a. The definition of current income taxes is clarified by defining such taxes to include current year estimates of federal and foreign income taxes, based on tax returns for the current year, tax contingencies computed in accordance with Issue Paper No. 5, and all amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in Issue Paper No. 3. In the case of a mutual life insurance company, current income tax includes the reporting entity’s best estimate of its equity tax for the current year, after recomputation (i.e., including the “true-up”) in accordance with the guidance contained in Emerging Accounting Issues Working Group Positions 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, and 95-3 & 4, Equity Tax.

b. The definition of current income tax recoverables is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities. The criteria for admissibility of current income tax recoverables is also modified by admitting them if they are reasonably expected to be recovered pursuant to Issue Paper No. 4.

c. Statutory accounting principles with respect to the recognition of income tax transactions between affiliated parties that file a consolidated income tax return are modified to ensure that such transactions are recognized consistently among all reporting entities.
d. Statutory accounting principles with respect to the computation of income taxes incurred in interim periods is modified by requiring the use of the estimated annual effective tax rate for purposes of computed income taxes incurred in interim periods as such a method allows for the comparison of income tax rates among reporting entities, recognizes that an interim period is an integral part of the annual accounting period, and adopts paragraphs 19 and 20 of APB 28.

e. Financial statement disclosure is expanded to include disclosure of the components of current income tax expense, DTAs and DTLs, information as to the portion of a reporting entity’s DTAs that are nonadmitted and, items for which DTLs have not been established in order to provide meaningful information to the users of a reporting entity’s financial statements.

f. Current statutory accounting practice of recording extraordinary amounts of taxes relating to prior years as a component of gains and losses in surplus has been changed to provide that all changes in estimates of income taxes incurred will be recorded in statutory income consistent with Issue Paper No. 3.

23. The definition of current income taxes is clarified to ensure that current income taxes incurred are computed in accordance with the Statement of Concepts, to enhance the comparability of financial statements, and, with respect to the inclusion of tax contingencies, to ensure consistency with the recognition principle of the Statement of Concepts which requires the recognition of liabilities as they are incurred.

24. The definition of current income tax recoverables, and their admissibility, is modified by defining such amounts as including all current income taxes reasonably expected to be received in a subsequent period, whether or not a return or claim has been filed with the taxing authorities, so that such amounts are recorded and admitted based on reasonably objective criteria (i.e., expectation of recovery) and not predicated on subjective criteria (e.g., receipt within a specific timeframe). Current statutory accounting principles’ use of subjective criteria precludes reporting entities that are continually under Internal Revenue Service (IRS) audit pursuant to the Coordinated Examination Program from admitting valid income tax recoverables since the IRS will not refund such amounts until an audit is completed. As a result, many of these taxpayers do not file amended income tax returns but rather present these valid claims to the IRS during the audit as “affirmative adjustments”.

25. The principles of FAS 109, including the recognition of DTAs and DTLs, are adopted with the following modifications:

a. For purposes of this issue paper, income taxes do not include state income taxes. State income taxes (including franchise taxes) shall be computed in accordance with Issue Paper No. 5 and shall be limited to (a) taxes due as a result of the current year’s taxable income calculated in accordance with state laws and regulations and (b) amounts incurred or received during the current year relating to prior periods, to the extent not previously provided as such amounts are deemed to be changes in accounting estimates. Property and casualty insurance companies shall report state income taxes as other underwriting expenses under the caption “Taxes, licenses, and fees.” Life and accident and health insurance companies shall report such amounts as general expense under the “Insurance taxes, licenses, and fees, excluding federal income taxes.” Other health entities shall report such amounts as general administration expenses under the caption “Taxes, licenses, and fees.” State income taxes are excluded from the definition of income taxes to ensure comparability of financial statements, since such taxes are generally not significant to the surplus of a reporting entity and, since not all state taxes are based on income.
b. In order to ensure that a reporting entity’s surplus is conservatively measured, the *more likely than not* criteria of paragraph 17(e) of FAS 109 is replaced by the realization criteria in paragraph 9 of this issue paper.

c. DTAs are not reduced by a valuation allowance. Instead, that portion of a reporting entity’s DTAs that is not realizable pursuant to this issue paper is nonadmitted.

d. Temporary differences do not include AVR, IMR, Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that “tax and loss” bonds have been purchased. Current statutory guidance on the accounting for “tax and loss” bonds is excerpted in paragraph 40 of this issue paper.

e. Changes in DTAs and DTLs, including amounts attributable to changes in tax rates and changes in tax status are not included in net income in accordance with paragraphs 27 and 28 of FAS 109, but rather are allocated to gains and losses in surplus pursuant to this issue paper.

f. Paragraphs 29 - 30, 36 - 37, 39, 41 - 42, 46 and 49 - 59 of FAS 109 are not adopted, inasmuch as they are not applicable to insurance companies or are inconsistent with other statutory accounting principles. Paragraph 47 of FAS 109 is adopted with modification to provide for the disclosures required for non-public reporting entities.

26. The recognition of DTAs and DTLs is consistent with the Statement of Concepts and Issue Paper Nos. 4 and 5, respectively. While Emerging Accounting Issues Working Group Position EI 89-2, Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes allows the recording of DTLs, this issue paper requires the recording of DTLs. In defining the objectives of statutory financial reporting the Statement of Concepts states:

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

27. Recognition of DTAs and DTLs and the requisite determination that the temporary differences underlying DTAs and DTLs will result in taxable or deductible amounts ensures that statutory surplus reflects the tax consequences of recorded events and is consistent with the assumptions inherent in the financial statements that the reported assets and liabilities will be recovered and settled, respectively. The conclusion reached with respect to the nonadmissibility of Section 847 deposits in Emerging Accounting Issues Working Group Position EI-93-4, Section 847 Deposits, need not be revisited as the tax effect of loss reserve discounting (i.e., a DTA) will be recognized, subject to a nonadmissibility test.

28. DTAs embody the three characteristics of assets, as described in Issue Paper No. 4, for the following reasons:

a. A DTA “embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows” inasmuch as deductible temporary differences reduce taxable income and taxes payable in future years thereby contributing indirectly to future net cash inflows,
b. A reporting entity has exclusive rights to the future benefit associated with its DTA and
c. A DTA is the tax effect of the difference between the tax basis of an asset or liability and
   its reported amount in the financial statements, and is therefore attributable to a
   “transaction or other event giving rise to the entity’s right to or control of the benefit
   [that] has already occurred.”

29. DTLs embody the three characteristics of liabilities, as described in Issue Paper No. 5, for the
    following reasons:
    a. Inasmuch as a DTL stems from a legal obligation imposed by a taxing authority, it
       “embodies a present duty or responsibility to one or more other entities that entails
       settlement by probable future transfer or use of assets at a specified or determinable date,
       on occurrence of a specified event, or on demand,”
    b. While a reporting entity may be able to delay the future reversal of the temporary
       differences, a DTL embodies a reporting entity’s duty or responsibility to pay a tax
       “leaving it little or no discretion to avoid the future sacrifice,” and
    c. A DTL is the tax effect of the difference between the tax basis of an asset or liability and
       its reported amount in the financial statements, and is therefore attributable to a
       “transaction or other event obligating the entity [that] has already happened.”

30. Temporary differences do not include differences, such as AVR, IMR, Schedule F penalties, or
    tax-exempt interest, inasmuch as these differences do not result in taxable or deductible amounts in future
    years when the related asset or liability for statutory reporting purposes is recovered or settled. Additionally, IMR
    is excluded from the definition of temporary differences since it is already net of current taxes paid (i.e., in essence a deferred tax has already been recorded). To the extent that a U.S.
    mortgage guaranty insurer has purchased “tax and loss” bonds, corresponding amounts of its statutory
    contingency reserve are excluded from the definition of temporary differences in order to preserve the
    statutory admissibility of “tax and loss” bonds and to ensure that the tax effect of the reserve is not double
    counted in a mortgage guaranty insurer’s surplus.

31. By adoption of the principles of FAS 109, as modified in this issue paper, temporary differences
    include unrealized gains and losses. As a result, unrealized gains and losses of reporting entities shall be
    recorded, net of any allocated DTA or DTL, in gains and losses in surplus. The amount allocated shall be
    computed in a manner consistent with paragraph 38 of FAS 109.

32. This statement rejects FASB Interpretation No. 18, Accounting for Income Taxes in Interim
    Periods…an interpretation of APB Opinion No. 28.

33. The following lists Accounting Principles Board Opinions that are adopted or rejected by this
    statement:
    a. Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit,”
       paragraphs 9—15 are adopted with modification to utilize the cost reduction method only
       and rejects all other paragraphs;
    b. Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the
       “Investment Credit,” is rejected in its entirety;
    c. Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966, paragraph 6 is
       adopted;
d. Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes—Special Areas*, paragraphs 1—3, 5—9, 12—13, and 15—18 are adopted, and paragraphs 19—25, and 31—33 are rejected;

e. Accounting Principles Board Opinion No. 28, *Interim Financial Reporting*, paragraphs 19 and 20 are adopted and all other paragraphs rejected;

34. The following lists FASB Technical Bulletins that are adopted or rejected by this statement:

a. FASB Technical Bulletin No. 79-9, *Accounting in Interim Periods for Changes in Income Tax Rates* is rejected in its entirety;

b. FASB Technical Bulletin No. 82-1, *Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases* is adopted in its entirety.

35. The following lists FASB Emerging Issues Task Force Issues that are adopted or rejected by this statement:

a. FASB Emerging Issues Task Force No. 91-8, *Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*, is rejected in its entirety;

b. FASB Emerging Issues Task Force No. 92-8, *Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*, is adopted in its entirety;

c. FASB Emerging Issues Task Force No. 93-13, *Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*, is rejected in its entirety;

d. FASB Emerging Issues Task Force No. 93-16, *Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*, is rejected in its entirety;

e. FASB Emerging Issues Task Force No. 93-17, *Recognition of Deferred Tax Assets for a Parent Company’s Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*, is adopted in its entirety;

f. FASB Emerging Issues Task Force No. 94-10, *Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*, is rejected in its entirety;

g. FASB Emerging Issues Task Force No. 95-9, *Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*, is rejected in its entirety;

h. FASB Emerging Issues Task Force No. 95-10, *Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*, is rejected in its entirety;

36. This statement rejects AICPA Accounting Interpretations, *Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4* in its entirety.

**Drafting Notes/Comments**
None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**


Beginning with the Revenue Act of 1921, the Internal Revenue Code incorporates certain sections which govern the federal income taxation of property/liability insurance companies. The 1986 Tax Reform Act ("TRA") dramatically changed the manner in which such insurers are taxed, repealing Sections 821 through 826 of the Code and eliminating the differences that previously existed in the taxation of mutual and stock property/liability companies. The taxation of property/liability insurers is governed by Section 831 and 832 of the Internal Revenue Code of 1986.

With the enactment of the TRA, not only were the differences in tax treatment between mutual and stock companies eliminated, but, for the first time, a single property/liability tax return was developed — Form 1120-PC. Gone are the Protection Against Loss ("PAL") account and Form 1120M for mutual property/liability insurers, although provisions concerning the runoff of existing PAL accounts still exist.

Section 832 of the Code continues to define “gross income” as:

“A combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. . .”

Small insurers continue to be eligible for different tax treatment, although they were also affected by the TRA. Any property/liability company with less than $350,000 per year in (the greater of) net written or direct written premiums is exempt from federal income taxation under Code Section 501(c)(15). Property/liability insurers with net written premiums or direct written premiums (whichever is greater) in excess of $350,000, but less than $1,200,000, may make an election to be taxed only on taxable investment income. In the case of a member of a controlled group of corporations, the direct or net written premiums of the controlled group are aggregated in order to determine if the company may make the election. The ownership test for a control group is 50%, rather than 80%, for purposes of determining eligibility for the small company provision.

Each company must establish an appropriate liability for federal income taxes payable in its annual statement. This liability must be sufficient to cover computed taxes for current and prior years that are currently payable (total income tax less estimated tax payments), and any additional taxes the company expects to pay.

This chapter considers the method of accounting for federal income tax, and the differences between annual statement “net income” and “taxable income.”

**Method of Accounting for Federal Income Taxes**

As mentioned above, the statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property/liability insurers. The insurance sections of the Internal Revenue Code in general provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement.
except where such basis conflicts with other preemptive provisions of the Code. Such preemptive provisions have been dramatically increased as a result of the 1986 TRA.

**Differences Between Annual Statement “Net Income” and “Taxable Income”**

Due to specific Internal Revenue Code provisions which affect determination of taxable income, there have always been differences between annual statement “net income” and “taxable income,” such as tax exempt interest income, depreciation expense, etc.

The TRA, however, introduced four major provisions at variance with annual statement accounting which increase the taxable income of property/liability insurers:

1. **Discounting of loss reserves.** Property/liability insurers are required to discount loss and loss adjustment expense reserves in the following manner:
   - The discount rate is a moving average of the mid-term applicable federal rate under Code Section 1274, which fluctuates from year to year;
   - The payout period is based on industry averages, but the company may elect to use its own experience;
   - The maximum payout period for former Schedule O lines is three years and ten years for all lines that were reported in Schedule P before the 1989 annual statement; and
   - There is an extension of the 10-year payout period for certain reserves remaining at the end of ten years.

   The impact of discounting is to spread the deduction for ultimate incurred losses and loss adjustment expenses over a number of years to reflect the assumed investment earnings on those reserves.

2. **Revenue Offset.** Property/liability insurers must include in taxable income annually 20% of the increase (decrease) in their unearned premium reserves.

   There is also a transition rule whereby 20% of a company’s unearned premium reserve at the end of 1986 is includable in taxable income ratably over a six year period beginning in 1987.

3. **Proration.** Property/liability insurers are now required to reduce their deduction for losses incurred by 15% of the sum of the tax exempt interest and the deduction for dividends received. This proration rule does not apply to tax exempt interest and the deductible portion of dividends received or accrued on stock or obligations acquired by the insurer before August 8, 1986.

4. **Alternative Minimum Tax.** A new corporate tax concept was introduced wherein a tax is imposed on a company’s “economic” income at a reduced rate of 20%. The corporation’s tax liability will be the higher of the regular tax or this alternative minimum tax.

   Certain tax preference items are added to a company’s (or a group’s) consolidated taxable income resulting in alternative minimum taxable income. Tax preferences should include:
   - 50% of excess of book income over taxable income adjusted for other tax preferences.
   - Interest on certain private activity municipal bonds issued after August 8, 1986.
- Accelerated depreciation on real and personal property, to the extent it is in excess of depreciation calculated under an alternative method.

Book income is annual statement net income for mutual insurance companies. For stock insurers that file GAAP financial statements, book income is GAAP net income. Beginning in 1990, this preference will be based on adjusted current earnings ("ACE"), similar to earnings and profits, rather than statutory income. Also in 1990, the preference will equal 75% of the excess of ACE over taxable income, plus other preferences.

(The Superfund Revenue Act of 1986 requires corporations to pay an "environmental" tax, set at an annual rate of $12 per $10,000 of alternative minimum taxable income, payable even if the corporation pays no alternative minimum tax. This tax of .12% is levied on a corporation’s modified alternative minimum taxable income over $2,000,000.)

**Other Additions To Annual Statement “Net Income”**

Examples of additions are:

1. Provisions for federal income taxes deducted in the annual statement;
2. Excess of realized capital losses over realized capital gains in the annual statement;
3. Gain on sale of capital assets in excess of annual statement gain;
4. Excess of annual statement depreciation and amortization over tax depreciation and amortization;
5. Cost of assets, leasehold improvements, acquisition of leases, and special assessments on real estate owned, which have been included as expenses in the annual statement, but which are capital improvements for tax purposes;
6. Charitable donations exceeding deductible limits;
7. Premiums for officers’ or employees’ life insurance policies where the company is the beneficiary;

**Deductions From Annual Statement “Net Income”**

Examples of deductions are:

1. Tax-exempt interest as reduced by proration;
2. Dividends received deduction as reduced by proration;
3. Excess of tax depreciation and amortization over annual statement depreciation and amortization;
4. Carry-forward of any allowable deductions, such as excess charitable contributions;
5. Operating or capital loss carry-forwards allowable to the company;
6. Federal income tax refunds included in “net income”;
7. Items previously not deductible for tax purposes that were charged to annual statement in prior years;
8. Loss on sale of capital assets in excess of annual statement loss.
* See above for discounting, revenue offset, proration and anticipation of salvage and subrogation.

**Reporting Federal Income Taxes**

Federal income taxes can appear in the following places in the annual statement:

- Recoverable federal income taxes are allowable as an admitted asset and appear as an asset on the balance sheet. Note, however, that the NAIC does not recognize as an admitted deferred asset "special estimated tax payments" authorized by Section 847 of the Internal Revenue Code.

Federal income taxes due or accrued are included as a liability on the “Liabilities, Surplus and Other Funds” page of the balance sheet.

Federal income taxes incurred during the year are reported as a deduction from income in the Underwriting and Investment Exhibit of the Statement of Income.

Federal income taxes incurred or refunded during the year relating to prior period adjustments are to be included with current year provisions for taxes, but in some instances, if material, they may be charged or credited directly to unassigned surplus in the capital and surplus account.

Also, a footnote to the Statement of Income discloses the amount of federal income taxes incurred and available for recoupment in the event of future net losses. Further, it discloses the amount of any net losses carried forward and available to offset future net income subject to federal income taxes.

Federal income taxes paid are included in the Statement of Changes in Financial Position.

**General Interrogatories** include a series of questions regarding federal income taxes. They disclose whether a consolidated return is filed and, if so, the methods used to allocate the taxes between the companies. (See Chapter 8-Other Admitted Assets.)

**Federal Income Tax Recoverable - Consolidated Return**

In the case of an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for federal income tax recoverable should reflect the source of the recoverable such as "Federal Income Tax Recoverable - Parent."

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating on a consolidated tax return provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and
2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and
3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and
4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and
5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.
38. Chapter 23, Federal Income Taxes, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual) provides the following guidance:

**Introduction**

With the passage of the Deficit Reduction Act of 1984, Congress substantially changed the taxation of life insurance companies under the U.S. Internal Revenue Code. From 1958 through 1983, life insurance companies were taxed under the provisions of the Life Insurance Company Income Tax Act of 1959 which prescribed a complex three phase taxing formula unique to such companies. The 1984 Act mandated a simpler single-phase basis of taxation which essentially parallels the taxation of the income of other corporations. Subsequent modifications have retained the basic single-phase system.

However, there are several aspects of determining life insurance company taxable income that are unique to the life insurance industry. The most notable of these are deductions for increases in life insurance company reserves, deductions for dividends to policyholders, the special treatment of the company’s share of tax exempt interest and dividends received deduction, and the small life insurance company deduction.

**Definition of a Life Insurance Company for Federal Income Tax Purposes**

To obtain the special treatment afforded life insurance companies under the Internal Revenue Code, a business enterprise must meet the Internal Revenue Code’s definition of a life insurance company. A life insurance company is defined as a company for which, during the taxable year, more than half of its business is the issuance of insurance and annuity contracts or the reinsuring of risks underwritten by insurance companies, provided that more than 50% of its total reserves consist of life insurance reserves and unearned premiums and unpaid losses on noncancellable life, accident, or health policies. As a result of this definition in the Internal Revenue Code, companies that are incorporated as life insurance companies under applicable state insurance laws may not qualify as life insurance companies for federal income tax purposes.

**Deduction for Increase in Reserves**

Life insurance companies are permitted deductions in each tax year for the net amount of the increase in:

- Life insurance reserves (as defined in the Internal Revenue Code).
- Unearned premiums and unpaid losses not included in life insurance reserves.
- Other items set forth in the Internal Revenue Code.

In general, a life insurance reserve is defined in the Internal Revenue Code as a liability amount which is required by state law and which:

- Is computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
- Recognizes the company’s future liability for unaccrued claims from life insurance, annuity, and noncancellable accident and health insurance contracts. Noncancellable accident and health insurance is defined to include guaranteed renewable accident and health insurance.

**Calculation of Life Insurance Reserves for Deduction Purposes**

Prior to the 1984 Act, a life insurance company’s reserves for federal income tax purposes were generally based upon those held in its statutory annual statement. As a result of the 1984 Act,
federal standards were established for the calculation of life insurance reserves for income tax purposes and may be summarized as follows:

- The reserve calculation method is specified—in general, a company is to use the Commissioners' Reserve Valuation Method (CRVM) for life insurance contracts, the Commissioners' Annuity Reserve Valuation Method (CARVM) for annuity contracts and a two-year full preliminary term for noncancellable accident and health insurance.

- The interest rate is specified—beginning in 1988 it has been the greater of:

  An interest rate determined by the Internal Revenue Service based on an average of monthly interest rates for certain Treasury obligations, referred to as the "applicable federal interest rate" (AFR), or
  
  The "prevailing state assumed interest rate", i.e., the highest interest rate which at least 26 states permit to be used for statutory annual statement reserves for such contracts.

- The mortality/morbidity basis is specified—the “prevailing commissioners’ standard tables for mortality and morbidity", i.e., the most recent tables adopted by the NAIC which at least 26 states permit to be used for reserve determination for such contracts. In the event there are no “prevailing commissioners’ standard tables", the Secretary of the Treasury is authorized to specify the mortality or morbidity tables to be used.

Life insurance companies are permitted to use the larger of the reserve amount calculated by the foregoing rules or the net surrender value of the contract to determine the reserve deduction for the tax year. In any event, the tax reserve cannot exceed the reserve amount shown on the company’s annual statement.

As a result of legislation in 1986, certain other reserves which generally are not discounted for annual statement purposes, such as accident and health unpaid claims, now must be discounted for tax deduction purposes using a discounting method and rate specified by the Internal Revenue Code.

**Deduction for Policyholder Dividends**

As a result of the 1984 Act, the deduction by a stock life insurance company for policyholder dividends paid or accrued during a taxable year generally is not subject to limitation. However, a mutual life insurance company is required by the Internal Revenue Code to reduce its deduction for policyholder dividends (and, next, its deduction for increase in reserves) by an amount referred to as the “differential earnings amount.” According to the 1984 Act Congressional Conference Report, "...This reduction reflects recognition that, to some extent, policyholder dividends paid by mutual companies are distributions of the companies’ earnings to the policyholders as owners...”

The Internal Revenue Code’s definition of “policyholder dividends” includes the following items:

- Amounts returned to policyholders where the amounts so returned were not fixed in the policy but, instead, depended on the experience of the company or the discretion of management.

- Excess interest, defined as any amount in the nature of interest paid or credited to policyholders in excess of the prevailing state assumed interest rate (rather than in excess of the minimum rate guaranteed in the contract).
- Premium adjustments, defined as any reduction in the premiums which would have been required to be paid under the contracts.

- Experience-rated refunds, defined as including a refund based on the experience of the policyholder.

Under the Internal Revenue Code, the differential earnings amount for mutual companies is determined by multiplying an individual company’s “average equity base” for the taxable year by the “differential earnings rate.” The average equity base is an amount calculated by each mutual company. It is based on specific rules in the Internal Revenue Code and includes a company’s capital and surplus. The differential earnings rate is computed by the Internal Revenue Service based on information reported by all mutual life insurance companies and the 50 largest stock life insurance companies. The rate for each year is announced by the Internal Revenue Service.

**Company’s Share of Tax-Exempt Interest and Dividends-Received Deduction**

In determining taxable income for most corporations, tax exempt interest is excluded and a deduction is allowed for a percent of United States source dividend income received. However, special rules apply as to life insurance companies. Life insurance companies are allowed to reduce taxable income by only the “company’s share” of the tax exempt interest and the dividends received deduction. The “company’s share” is calculated using specific rules in the Internal Revenue Code.

**Small Life Insurance Company Deduction**

For life insurance companies with assets of less than $500 million, a special small company deduction from taxable income is allowed. The deduction is equal to 60% of tentative life insurance company taxable income up to $3 million. This deduction is reduced by 15% of tentative life insurance company taxable income between $3 million and $15 million (at $15 million, the deduction becomes zero). For purposes of the $500 million asset ceiling, all members of a controlled group, including nonlife insurance companies, are treated as one company.

**Other Considerations**

**Alternative Minimum Tax**

The Tax Reform Act of 1986 replaced the prior add-on minimum tax with a new alternative minimum tax (AMT) on corporations. The AMT is, in substance, an alternative tax calculation which applies if it exceeds the regular tax.

The AMT is applicable to all companies, including life insurance companies, and is intended to ensure that no taxpayer with substantial economic income can avoid income tax through the use of exclusions, deductions, and credits. The AMT is equal to 20% of the recomputed taxable income that recognizes certain adjustments and items of tax preference. The significant adjustment for life insurance companies for the tax years 1987, 1988, and 1989 was the book income adjustment. This adjustment increases (but does not decrease) the alternative minimum taxable income by 50% of the difference between pretax financial statement income and taxable income. Another adjustment, applicable only to mutual companies, limits the reduction in book income for policyholder dividends.

Starting with 1990, the calculation of alternative minimum taxable income has been based on an earnings and profits concept rather than a book income adjustment. Among the adjustments for tax years beginning after 1989 that are of importance to life insurance companies are a requirement to amortize acquisition costs, the addback of the company’s share of tax exempt interest and the dividends received deduction, and the addback of the small company deduction.

**Policyholders’ Surplus Account**
A stock life insurance company may be required to maintain a memorandum account for tax purposes called the “policyholders’ surplus account.” The policyholders’ surplus account represents, in effect, income of a stock life insurance company for which tax was deferred under pre-1984 tax rules. Under the 1984 Act, there can be no additions to the policyholders’ surplus account after 1983. However, reductions in the policyholders’ surplus account are included in taxable income in the year in which such reductions occur (referred to as “Phase III income”).

Phase III income can occur as a result of any of the following circumstances:

- The company makes certain distributions to shareholders, either as dividends or redemptions of stock, which are in excess of the shareholders’ surplus account and are considered as reductions of the policyholders’ surplus account.
- The policyholders’ surplus account exceeds certain maximums based on net premiums and life insurance reserves.
- The company ceases to qualify as a life insurance company for tax purposes.

Statutory Treatment of Federal Income Taxes

In addition to United States income taxes, federal income taxes in the annual statement include income taxes levied by foreign countries and United States possessions. The handling of federal income taxes can appear in different places in the annual statement. These places are:

- Federal income tax recoverable is reported as an asset subject to asset admissibility criteria.
- Federal income taxes due or accrued are reported as a liability.
- Federal income taxes incurred during the year (excluding tax on capital gains) are deducted in the Summary of Operations.
- Federal income taxes incurred during the year relating to prior-period adjustments generally are included with current year taxes. However, in extraordinary instances it may be appropriate to charge such adjustments directly to the surplus account.
- Federal income taxes incurred during the year on capital gains are shown as a reduction of Gross Capital Gains and Losses on Investments.

Insurers may recognize transactions arising from income tax allocations among companies participating in a consolidated return, provided certain conditions are met.

39. Chapter 19, Expenses, of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to state income taxes:

Expense Group Classifications

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:

3. Taxes, Licenses, and Fees
These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

40. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement of the P&C Accounting Practices and Procedures Manual provides the following guidance with respect to “tax and loss” bonds of U.S. mortgage guaranty insurance companies:

BONDS

U.S. Mortgage Guaranty Tax and Loss Bonds

To obtain a current federal income tax benefit derived from annual additions to the statutory contingency reserve (for tax purposes, the “mortgage guaranty account”), mortgage guaranty insurers must purchase “tax and loss” bonds to the extent of such benefits. These bonds are noninterest bearing obligations of the U.S. Treasury, and mature 10 years after issue. The usual purpose of “tax and loss” bonds is to satisfy taxes that will be due in 10 years when the tax benefit is reversed; however, the bonds may be redeemed earlier in the event of excess underwriting losses. (See chapter on Contingency Reserve.) These bonds are carried as an asset for statutory purposes allowing mortgage insurers to conserve capital.

FEDERAL INCOME TAXES

Contingency Reserve (for Tax Purposes, the "Mortgage Guaranty Account")

Under IRS Code Section 832(e), mortgage guaranty insurers are permitted to deduct from gross income the annual addition to the contingency reserve. The tax deduction is generally an amount equal to (a) 50% of earned premium or (b) taxable income as computed prior to this special deduction if less than 50% of earned premium. Annual deductions not utilized for tax purposes during the current period may be carried forward for eight years on a basis similar to net operating losses. The amount deducted must be restored to gross income after ten years; however, the amount may be restored to gross income at an earlier date in the event of a taxable net operating loss.

The tax deduction is permitted only if special “U.S. Mortgage Guaranty Tax and Loss Bonds” are purchased in an amount equal to the tax benefit derived from the deduction (see section on “Bonds”). Upon redemption the “tax and loss” bonds can be used to satisfy the additional tax liability that arises when the deduction is restored to income.

The purchase of “tax and loss” bonds will often defer the entire tax expense that would otherwise be payable on the current year’s taxable income.

41. Chapter 22, General Expenses and Taxes, Licenses and Fees of the Life/A&H Accounting Practices and Procedures Manual contains the following guidance with respect to state income taxes:

Classification of Expenses

The following points should be noted with respect to specific classifications of expenses:
12. Taxes, licenses and fees generally include all payments to federal, state, local, and foreign governments with the exception of federal income taxes.

Taxes, Licenses, and Fees Due or Accrued

Taxes, licenses, and fees which are unpaid but applicable to the accounting period should be accrued and reported as a liability in the balance sheet. With respect to premium taxes and state income taxes, the amount accrued should relate to the related premiums or taxable income recorded in the period, less, of course, prepayments of those taxes. Payroll taxes accrued should include all unpaid taxes applicable to salaries and wages which have been paid, plus taxes applicable to accrued payroll.

42. The NAIC Annual Statement Instructions for Property and Casualty Insurance Companies provides the following guidance with respect to federal income taxes:

**UNDERWRITING AND INVESTMENT EXHIBIT**

**STATEMENT OF INCOME**

**Line 15 - Federal and Foreign Income Taxes Incurred**

Include: Current year provisions for federal and foreign income taxes, and federal and foreign income taxes incurred or refunded during the year relating to prior period adjustments. In some instances such prior period adjustments, if material, may be charged or credited directly to Unassigned Surplus in the “Capital and Surplus Account.”

The statutory method of accounting as used in the annual statement plays the key role in determining the federal income tax liability of property and casualty insurance companies. The insurance sections of the Internal Revenue Code, in general, provide that taxable income should be computed on the basis of the underwriting and investment exhibits of the annual statement except where such basis conflicts with other preemptive provisions of the Internal Revenue Code.

The amount of this item equals Line 14 of Exhibit 2, adjusted for reserves in Line 6 on page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

The amount of this item equals Line 9, Page 5, adjusted for reserves in Line 6 on Page 3 of the current and prior years’ statements, and recoverables in Line 14, Column 4 on Page 2 of current and prior years’ statements.

**CAPITAL AND SURPLUS ACCOUNT**

**Line 29 - Extraordinary Amounts of Taxes for Prior Years**

Include: Interest and expenses related to prior year taxes on this line.
Line 14 - Federal Income tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:

1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and
2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and
3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and
4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and
5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS


Instruction:

a. If the company’s federal income tax return is combined with those of any other entity or entities, provide the following:
   1. A list of names of the entities with whom the company’s federal income tax return is combined for the current year.
   2. The substance of the written agreement, approved by the company’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

b. If the company incurred federal income taxes which are available for recoupment in the event of future net losses, indicate the amount available for recoupment from the current year, the first preceding year, and the second preceding year.

c. If the company incurred net losses which are carried forward and are available to offset future net income subject to income taxes, indicate the amounts carried
forward from the current year and each of the six years preceding the current year.

Illustration:

a. 1. The Company’s federal income tax return is combined with the following entities:

The Affiliated Company

2. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

b. The amount of federal income taxes incurred and available for recoupment in the event of future net losses is:

- current year $__________;
- first preceding year $__________;
- second preceding year $__________

c. The amount of net losses carried forward and available to offset future net income subject to federal income taxes is:

- current year $__________;
- first preceding year $__________;
- second preceding year $__________;
- third preceding year $__________;
- fourth preceding year $__________;
- fifth preceding year $__________;
- sixth preceding year $__________

43. The NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies provides the following guidance with respect to federal income taxes:

SUMMARY OF OPERATIONS (EXCLUDING UNREALIZED CAPITAL GAINS & LOSSES)

Line 30 - Federal Income Taxes Incurred

Include: Income and excess profits taxes, of any foreign country or of any possession of the U.S., incurred on operations.

Exclude: Taxes on capital gains and Extraordinary amounts of taxes relating to prior years.

The total of the amount in Line 30 minus extraordinary amounts of taxes reported in the “Details of Write-ins Aggregated at Line 46 for Gains and Losses in Surplus” on Line 46 plus Exhibit 3, Footnote (a), Line 1, Column B should be equal to Exhibit 12, Line 23.2 plus Page 3, Line 14A, current year, plus Page 2, Line 14, prior year, minus Page 3, Line 14A, prior year, minus Page 2, Line 14, Column 4, current year.

ASSETS, PAGE 2

Line 14 - Federal Income Tax Recoverable

In the case on an insurer that is a party to a consolidated tax return with one or more affiliates, the caption for Federal Income Tax Recoverable should reflect the source of the recoverable; e.g., Federal Income Tax Recoverable - Parent.

Insurers may recognize intercompany transactions arising from income tax allocations among companies participating in a consolidated income tax return, provided the following conditions are met:
1. There is a written agreement describing the method of allocation and the manner in which intercompany balances will be settled, and

2. Such agreement requires that any intercompany balance will be settled within a reasonable time following the filing of the consolidated tax return, and

3. Such agreement complies with regulations promulgated by the Internal Revenue Service, and

4. Any receivables arising out of such allocation meet the criteria for admitted assets as prescribed by the domiciliary state of the insurer, and

5. Liabilities which offset the related intercompany receivables are established by other companies participating in the consolidated tax return.

NOTES TO FINANCIAL STATEMENTS

5. Federal Income Tax Allocation

Instruction:

If the company’s federal income tax return is combined with those of any other entity or entities, provide the following:

a. A list of names of the entities with whom the company’s federal income tax return is combined for the current year.

b. The substance of the written agreement, approved by the company’s Board of Directors, which sets forth the manner in which the total combined federal income tax for all entities is allocated to each entity which is a party to the consolidation. (If no written agreement has been executed, give an explanation of why such an agreement has not been executed.) Describe the method of allocation, setting forth the manner in which the company has an enforceable right to recoup federal income taxes in the event of future net losses which it may incur or to recoup its net losses carried forward as an offset to future net income subject to federal income taxes.

Illustration:

a. The Company’s federal income tax return is combined with the following entities:

   The Affiliated Company

b. The method of allocation between the companies is subject to written agreement, approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter.

44. Emerging Accounting Issues Working Group Position EI-86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies, provides the following guidance:

True-Up of Federal Income Taxes for Mutual Life Insurance Companies

The second issue discussed was adjustment of the ownership differential earnings amount provided under the Deficit Reduction Act of 1984. Attached to these minutes is a memorandum prepared by Ernst & Whinney which provided the background material for the discussion.
Accounting issues discussed were as follows:

1. What is the most appropriate option for mutual life insurers to adopt in accruing for 1984 and 1985 in the absence of an announced differential rate by the U.S. Treasury?

2. Should the adjustments to federal income taxes of prior years’ tax liability relative to the true–up be reported through operations or as a direct charge to surplus?

The working group concluded the following:

1. “Best estimates” should be used in accruing for the 1984 and 1985 tax liabilities in the absence of an announced differential rate by the U.S. Treasury.

2. Adjustments of prior years’ tax liability relative to the true–up should be reported through the operations statement.

45. Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986, provides the following guidance (However, note that reference to the FASB relates to consideration of deferred taxes pursuant to FASB Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes, which was superseded by FAS 109):

Accounting for Impact of the Tax Reform Act of 1986 (Loss Reserves Discounting)

The question of accounting on a statutory basis for the implications of tax reform was initially raised by Mary Jan Robertson, Vice President–Controller of United Capital Insurance Company. Subsequent to, and, independent of her request, tax reform impact questions were also referred to the Emerging Issues Working Group by action of the Financial Condition (EX4) Subcommittee.

The Tax Reform Act of 1986 made significant changes in the taxation of property and casualty insurance companies. Among the changes are “fresh start” provisions, loss reserve discounting, limitation in the deduction of the unearned premium, taxation of a portion of previously tax–exempt income, imposition of an alternative minimum tax in some cases and lower rates. The act changes the timing of tax payments and taxable income may be considerably higher than before, particularly in the first few years:

The working group considered the following issues:

1. Should the loss reserve discounting required for federal tax purposes be reflected in the insurer’s statutory statement?

The working group concluded that loss reserve discounting required for federal tax purposes was not an acceptable statutory accounting treatment.

2. Should a deferred tax asset, i.e., prepaid income taxes, arising from current timing differences be permitted on a statutory basis?

The consensus of the working group was that a deferred tax asset should not be permitted for statutory accounting purposes. The consensus was based, among other things, on the following:

a. The asset is not convertible to cash; it generally only reflects timing differences.

b. The asset is not recoverable within a definitive and short (1 to 2 years) time frame nor is the value readily determinable.

c. Statutory accounting has not previously recognized prepaid or deferred liability items (e.g., prepaid rent and deferred acquisition expenses).
d. In the majority of companies, i.e., those with growing premium volume and increasing loss reserve levels, the deferred tax asset would continually grow, probably to a very significant size.

The Financial Accounting Standard Board (FASB) has also reviewed this issue. FASB may allow some balance sheet recognition of a deferred tax asset, but it will be limited to a 3–year carryback amount if the amount and calculation thereof is clearly demonstrable. The working group believes in most cases, this will provide insignificant relief to property/casualty insurers.

The working group recommends to all insurance departments and to the NAIC Examiner Team that their financial analysis process take into consideration the impact on surplus caused by the new tax law. In some cases, effective tax rates will be very high, in excess of 100%, and that obviously will impact surplus. As a result, IRIS tests and other financial ratios which are surplus dependent may be distorted. Examiners and analysts should be cognizant of tax impact when evaluating companies. In certain situations, analytical recognition of additional equity resulting from deferred or prepaid taxes should be considered when determining financial stability and writing capacity. The working group believes this will be very pertinent with respect to new, growing companies writing long tail lines and to small, monoline, professional malpractice companies.

46. Emerging Accounting Issues Working Group Position EI 89-2, *Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes*, provides the following guidance on deferred taxes:

**Establishing a Liability for Deferred Federal Income Taxes for Statutory Accounting Purposes**

The issue summary for this topic was also prepared by Mr. Schaefer of the Michigan Insurance Bureau. A Michigan property and casualty insurer had established a liability for deferred federal income taxes consisting of a protection against loss account, unrealized gains from securities purchased at a discount and unrealized gains or losses from the write-up or write-down of the market value on stocks. While statutory accounting allows the deferral of taxes through the establishment of a P.A.L. account, the 1986 Tax Reform Act repealed the deduction for such an account.

The issue identified was:

Should the reporting of a liability for deferred federal income taxes be allowed under statutory accounting principles?

The working group concluded that while the existing accounting does not prohibit the establishment of a deferred tax liability, such a liability is not required. If an insurer does establish such a liability, it should be done on a consistent basis from year to year. In accordance with present annual statement instructions, it should not be included in the federal income tax liability.

47. Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits, provides the following guidance on the asset admissibility of these deposits:

2. **Section 847 Deposits (Prepaid Federal Income Taxes)**

This issue submitted by Dakota Truck Underwriters (Attachment B) was first considered by the working group in September 1993 (EI 93-3). The discussion at that meeting revealed that additional research was needed to provide information to the working group. John Baily (Coopers & Lybrand) summarized the result of such research (Attachment C). He indicated that this issue was not unlike the general issue of deferred tax assets considered and rejected by the working group previously.
The working group voted to reject the recommendation to allow reciprocal insurers an admitted asset for Section 847 deposits. The working group also reiterated its position against deferred taxes for statutory purposes.

48. Emerging Accounting Issues Working Group Position EI 95-3, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer’s equity tax:

Norris Clark (Calif.) summarized an issue submitted by Martin Carus (N.Y.) (Attachment A) regarding a component of federal income taxes for mutual life insurance companies commonly referred to as the “equity tax.” The question is whether it is more appropriate to charge that component of federal income taxes directly to surplus or through operations as income tax expense.

Armand de Palo (The Guardian Life Insurance Company of America) was recognized to present some additional information in support for charging the “equity tax” directly to surplus (Attachment B). Mr. Clark distributed minutes from a 1986 meeting of the working group (Attachment C) that include a discussion of this topic, and a recent letter received from John J. Palmer (Life of Virginia) concerning the issue (Attachment D).

After further discussion, the working group reached a tentative consensus that this component of federal income taxes should be recorded as tax expense in the summary of operations and should not be charged directly to surplus. The issue will be further discussed at the Winter National Meeting in San Antonio in anticipation of reaching a final consensus.

49. Emerging Accounting Issues Working Group Position EI 95-4, *Equity Tax*, provides the following guidance on statutory accounting for a mutual life insurer’s equity tax:

1. **Equity Tax**

Norris Clark (Calif.) summarized the issue and reviewed the preliminary consensus from the Fall National Meeting that the component of federal income taxes known as the “equity tax” should be recorded as tax expense in the summary of operations and should not be charged directly to surplus.

After further discussion the working group affirmed the preliminary conclusion.

**Generally Accepted Accounting Principles**

50. FAS 109 provides the following relevant guidance:

**STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

**SCOPE**

3. This Statement establishes the standards of financial accounting and reporting for income taxes that are currently payable and for the tax consequences of:

   a. Revenues, expenses, gains, or losses that are included in taxable income of an earlier or later year than the year in which they are recognized in financial income
   
   b. Other events that create differences between the tax bases of assets and liabilities and their amounts for financial reporting
   
   c. Operating loss or tax credit carrybacks for refunds of taxes paid in prior years and carryforwards to reduce taxes payable in future years.

**Objectives and Basic Principles**

6. One objective of accounting for income taxes is to recognize the amount of taxes payable or refundable for the current year. A second objective is to recognize deferred tax liabilities and
assets for the future tax consequences of events\(^3\) that have been recognized in an enterprise’s financial statements or tax returns.

\[\text{\footnotesize\textsuperscript{3}}\text{Some events do not have tax consequences. Certain revenues are exempt for taxation and certain expenses are not deductible. In the United States, for example, interest earned on certain municipal obligations is not taxable and fines are not deductible.}\]

7. Ideally, the second objective might be stated more specifically to recognize the expected future tax consequences of events that have been recognized in the financial statements or tax returns. However, the objective is realistically constrained because (a) the tax payment or refund that results from a particular tax return is a joint result of all the items included in that return, (b) taxes that will be paid or refunded in future years are the joint result of events of the current or prior years and events of future years, and (c) information available about the future is limited. As a result, attribution of taxes to individual items and events is arbitrary and, except in the simplest situations, requires estimates and approximations.

8. To implement the objectives in light of these constraints, the following basic principles (the only exceptions are identified in paragraph 9) are applied in accounting for income taxes at the date of the financial statements:

a. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.

b. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.

c. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted law; the effects of future changes in tax laws or rates are not anticipated.

d. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

9. The only exceptions in applying those basic principles are that this Statement:

a. Continues certain exceptions to the requirements for recognition of deferred taxes for the areas addressed by APB Opinion No. 23, Accounting for Income Taxes - Special Areas, as amended by this Statement (paragraphs 31-34)

b. Provides special transitional procedures for temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises (paragraph 32)

c. Does not amend accounting for leveraged leases as required by FASB Statement No. 13, Accounting for Leases, and FASB Interpretation No. 21, Accounting for Leases in a Business Combination (paragraphs 256-258)

d. Prohibits recognition of a deferred tax liability or asset related to goodwill (or the portion thereof) for which amortization is not deductible for tax purposes (paragraph 30)

e. Does not amend Accounting Research Bulletin No. 51, Consolidated Financial Statements, for income taxes paid on intercompany profits on assets remaining within the group, and prohibits recognition of a deferred tax asset for the difference between the tax basis of the assets in the buyer’s tax jurisdiction and their cost as reported in the consolidated financial statements

f. Prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities that, under FASB Statement No. 52, Foreign Currency Translation, are remeasured from the local currency into the functional currency using historical exchange rates that result from (1) changes in exchange rates or (2) indexing for tax purposes.
Temporary Differences

10. Income taxes currently payable\(^4\) for a particular year usually include the tax consequences of most events that are recognized in the financial statements for that year. However, because tax laws and financial accounting standards differ in their recognition and measurement of assets, liabilities, equity, revenues, expenses, gains, and losses, differences arise between:

a. The amount of taxable income and pretax financial income for a year
b. The tax bases of assets or liabilities and their reported amounts in financial statements.

\(^4\) References in this Statement to income taxes currently payable and (total) income tax expense are intended to include also income taxes currently refundable and (total) income tax benefit, respectively.

11. An assumption inherent in an enterprise’s statement of financial position prepared in accordance with generally accepted accounting principles is that the reported amounts of assets and liabilities will be recovered and settled, respectively. Based on that assumption, a difference between the tax basis of an asset or a liability and its reported amount in the statement of financial position will result in taxable or deductible amounts in some future year(s) when the reported amounts of assets are recovered and the reported amounts of liabilities are settled. Examples follow:

a. Revenues or gains that are taxable after they are recognized in financial income. An asset (for example, a receivable from an installment sale) may be recognized for revenues or gains that will result in future taxable amounts when the asset is recovered.

b. Expenses or losses that are deductible after they are recognized in financial income. A liability (for example, a product warranty liability) may be recognized for expenses or losses that will result in future tax deductible amounts when the liability is settled.

c. Revenues or gains that are taxable before they are recognized in financial income. A liability (for example, subscriptions received in advance) may be recognized for an advance payment for goods or services to be provided in future years. For tax purposes, the advance payment is included in taxable income upon the receipt of cash. Future sacrifices to provide goods or services (or future refunds to those who cancel their orders) will result in future tax deductible amounts when the liability is settled.

d. Expenses or losses that are deductible before they are recognized in financial income. The cost of an asset (for example, depreciable personal property) may have been deducted for tax purposes faster than it was depreciated for financial reporting. Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

e. A reduction in the tax basis of depreciable assets because of tax credits.\(^5\) Amounts received upon future recovery of the amount of the asset for financial reporting will exceed the remaining tax basis of the asset, and the excess will be taxable when the asset is recovered.

f. ITC accounted for by the deferral method. Under Opinion 2, ITC is viewed and accounted for as a reduction of the cost of the related asset (even though, for financial statement presentation, deferred ITC may be reported as deferred income). Amounts received upon future recovery of the reduced cost of the asset for financial reporting will be less than the tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

\(^5\)
g. An increase in the tax basis of assets because of indexing whenever the local currency is the functional currency. The tax law for a particular tax jurisdiction might require adjustment of the tax basis of a depreciable (or other) asset for the effects of inflation. The inflation-adjusted tax basis of the asset would be used to compute future tax deductions for depreciation or to compute gain or loss on sale of the asset. Amounts received upon future recovery of the local currency historical cost of the asset will be less than the remaining tax basis of the asset, and the difference will be tax deductible when the asset is recovered.

h. Business combinations accounted for by the purchase method. There may be differences between the assigned values and the tax bases of the assets and liabilities recognized in a business combination accounted for as a purchase under APB Opinion No. 16, Business Combinations. Those differences will result in taxable or deductible amounts when the reported amounts of the assets and liabilities are recovered and settled, respectively.

5 The Tax Equity and Fiscal Responsibility Act of 1982 provided taxpayers with the choice of either (a) taking the full amount of Accelerated Cost Recovery System (ACRS) deductions and a reduced tax credit (that is, investment tax credit and certain other tax credits) or (b) taking the full tax credit and a reduced amount of ACRS deductions.

Recognition and Measurement

16. An enterprise shall recognize a deferred tax liability or asset for all temporary differences and operating loss and tax credit carryforwards in accordance with the provisions of paragraph 17. Deferred tax expense or benefit is the change during the year in an enterprise’s deferred tax liabilities and assets. For deferred tax liabilities and assets acquired in a purchase business combination during the year, it is the change since the combination date. Total income tax expense or benefit for the year is the sum of deferred tax expense or benefit and income taxes currently payable or refundable.

6 Refer to paragraph 9. A deferred tax liability shall be recognized for the temporary differences addressed by Opinion 23 in accordance with the requirements of this Statement (paragraphs 31-34) and that Opinion, as amended.

7 Paragraph 230 addresses the manner of reporting the transaction gain or loss that is included in the net change in a deferred tax liability or asset when the reporting currency is the functional currency.

17. Deferred taxes shall be determined separately for each tax-paying component (an individual entity or group of entities that is consolidated for tax purposes) in each tax jurisdiction. That determination includes the following procedures:

a. Identify (1) the types and amounts of existing temporary differences and (2) the nature and amount of each type of operating loss and tax credit carryforward and the remaining length of the carryforward period

b. Measure the total deferred tax liability for taxable temporary differences using the applicable tax rate (paragraph 18)

c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate

d. Measure deferred tax assets for each type of tax credit carryforward

e. Reduce deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

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18. The objective is to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized. Under current U.S. federal tax law, if taxable income exceeds a specified amount, all taxable income is taxed, in substance, at a single flat rate. That rate shall be used for measurement of a deferred tax liability or asset by enterprises for which graduated tax rates are not a significant factor. Enterprises for which graduated tax rates are a significant factor shall measure a deferred tax liability or asset using the average graduated tax rate applicable to the amount of estimated annual taxable income in the periods in which the deferred tax liability or asset is estimated to be settled or realized (paragraph 236). Other provisions of enacted tax laws should be considered when determining the tax rate to apply to certain types of temporary differences and carryforwards (for example, the tax law may provide for different tax rates on ordinary income and capital gains). If there is a phased-in change in tax rates, determination of the applicable tax rate requires knowledge about when deferred tax liabilities and assets will be settled and realized.

19. In the U.S. federal tax jurisdiction, the applicable tax rate is the regular tax rate, and a deferred tax asset is recognized for alternative minimum tax credit carryforwards in accordance with the provisions of paragraph 17(d) and (e) of this Statement. If alternative tax systems exist in jurisdictions other than the U.S. federal jurisdiction, the applicable tax rate is determined in a manner consistent with the tax law after giving consideration to any interaction (that is, a mechanism similar to the U.S. alternative minimum tax credit) between the two systems.

20. All available evidence, both positive and negative, should be considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

21. Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

   a. Future reversals of existing taxable temporary differences
   b. Future taxable income exclusive of reversing temporary differences and carryforwards
   c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law
   d. Tax-planning strategies (paragraph 22) that would, if necessary, be implemented to, for example:
      (1) Accelerate taxable amounts to utilize expiring carryforwards
      (2) Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
      (3) Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

22. In some circumstances, there are actions (including elections for tax purposes) that (a) are prudent and feasible, (b) an enterprise ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused, and (c) would result in realization...
of deferred tax assets. This Statement refers to those actions as tax-planning strategies. An enterprise shall consider tax-planning strategies in determining the amount of valuation allowance required. Significant expenses to implement a tax-planning strategy or any significant losses that would be recognized if that strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) shall be included in the valuation allowance. Refer to paragraphs 246-251 for additional guidance.

23. Forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years. Other examples of negative evidence include (but are not limited to) the following:
   a. A history of operating loss or tax credit carryforwards expiring unused
   b. Losses expected in early future years (by a presently profitable entity)
   c. Unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years
   d. A carryback, carryforward period that is so brief that it would limit realization of tax benefits if (1) a significant deductible temporary difference is expected to reverse in a single year or (2) the enterprise operates in a traditionally cyclical business.

24. Examples (not prerequisites) of positive evidence that might support a conclusion that a valuation allowance is not needed when there is negative evidence include (but are not limited to) the following:
   a. Existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred tax asset based on existing sales prices and cost structures
   b. An excess of appreciated asset value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred tax asset
   c. A strong earnings history exclusive of the loss that created the future deductible amount (tax loss carryforward or deductible temporary difference) coupled with evidence indicating that the loss (for example, an unusual, infrequent, or extraordinary item) is an aberration rather than a continuing condition.

25. An enterprise must use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.

An Enacted Change in Tax Laws or Rates

27. Deferred tax liabilities and assets shall be adjusted for the effect of a change in tax laws or rates. The effect shall be included in income from continuing operations for the period that includes the enactment date.

A Change in Tax Status of an Enterprise

28. An enterprise's tax status may change from nontaxable to taxable or from taxable to nontaxable. An example is a change from a partnership to a corporation and vice versa. A deferred tax liability or asset shall be recognized for temporary differences in accordance with the requirements of this Statement at the date that a nontaxable enterprise becomes a taxable enterprise. A deferred tax liability or asset shall be eliminated at the date an enterprise ceases to be a taxable enterprise. In either case, the effect of (a) an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and (b) a change in tax status that results from a change in tax law is recognized on the enactment date.
The effect of recognizing or eliminating the deferred tax liability or asset shall be included in income from continuing operations.

**Opinion 23 and U.S. Steamship Enterprise Temporary Differences**

31. A deferred tax liability is not recognized for the following types of temporary differences unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

   a. An excess of the amount for financial reporting over the tax basis of an investment in a foreign subsidiary or a foreign corporate joint venture as defined in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, that is essentially permanent in duration.

   b. Undistributed earnings of a domestic subsidiary or a domestic corporate joint venture that is essentially permanent in duration that arose in fiscal years beginning on or before December 15, 1992.

   c. “Bad Debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrift lenders”) that arose in tax years beginning before December 31, 1987 (that is, the base year amount).

   d. “Policyholders’ surplus” of stock life insurance companies that arose in fiscal years beginning on or before December 15, 1992.

The indefinite reversal criterion of Opinion 23 shall not be applied to analogous types of temporary differences.

32. A deferred tax liability shall be recognized for the following types of taxable temporary differences:

   a. An excess of the amount for financial reporting over the tax basis of an investment in a domestic subsidiary that arises in fiscal years beginning after December 15, 1992.

   b. An excess of the amount for financial reporting over the tax basis of an investment in a 50-percent-or-less-owned investee except as provided in paragraph 31(a) and (b) for a corporate joint venture that is essentially permanent in duration.

   c. “Bad debt reserves” for tax purposes of U.S. savings and loan associations (and other “qualified thrift lenders”) that arise in tax years beginning after December 31, 1987 (that is, amounts in excess of the base-year amount).

The tax effects of temporary differences related to deposits in statutory reserve funds by U.S. steamship enterprises that arose in fiscal years beginning on or before December 15, 1992 and that were not previously recognized shall be recognized when those temporary differences reverse or in their entirety at the beginning of the fiscal year for which this Statement is first applied.

33. Whether an excess of the amount for financial reporting over the tax basis of an investment in a more-than-50-percent-owned domestic subsidiary is a taxable temporary difference must be assessed. It is not a taxable temporary difference if the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. For example, under current U.S. federal tax law:
a. An enterprise may elect to determine taxable gain or loss on the liquidation of an 80-percent-or-more-owned subsidiary by reference to the tax basis of the subsidiary's net assets rather than by reference to the parent company's tax basis for the stock of that subsidiary.

b. An enterprise may execute a statutory merger whereby a subsidiary is merged into the parent company, the minority shareholders receive stock of the parent, the subsidiary's stock is cancelled, and no taxable gain or loss results if the continuity of ownership, continuity of business enterprise, and certain other requirements of the tax law are met.

Some elections for tax purposes are available only if the parent company owns a specified percentage of the subsidiary's stock. The parent company sometimes may own less than that specified percentage, and the price per share to acquire a minority interest may significantly exceed the per share equivalent of the amount reported as minority interest in the consolidated financial statements. In those circumstances, the excess of the amount for financial reporting over the tax basis of the parent's investment in the subsidiary is not a taxable temporary difference if settlement of the minority interest is expected to occur at the point in time when settlement would not result in a significant cost. That could occur, for example, toward the end of the life of the subsidiary, after it has recovered and settled most of its assets and liabilities, respectively. The fair value of the minority interest ordinarily will approximately equal its percentage of the subsidiary's net assets if those net assets consist primarily of cash.

34. A deferred tax asset shall be recognized for an excess of the tax basis over the amount for financial reporting of an investment in a subsidiary or corporate joint venture that is essentially permanent in duration only if it is apparent that the temporary difference will reverse in the foreseeable future. The need for a valuation allowance for that deferred tax asset and other deferred tax assets related to Opinion 23 temporary differences (for example, a deferred tax asset for foreign tax credit carryforwards or for a savings and loan association's bad-debt reserve for financial reporting) shall be assessed. Paragraph 21 identifies four sources of taxable income to be considered in determining the need for and amount of a valuation allowance for those and other deferred tax assets. One source is future reversals of temporary differences. Future reversals of taxable differences for which a deferred tax liability has not been recognized based on the exceptions cited in paragraph 31, however, shall not be considered. Another source is future taxable income exclusive of reversing temporary differences and carryforwards. Future distributions of future earnings of a subsidiary or corporate joint venture, however, shall not be considered except to the extent that a deferred tax liability has been recognized for existing undistributed earnings or earnings have been remitted in the past.

**Intraperiod Tax Allocation**

35. Income tax expense or benefit for the year shall be allocated among continuing operations, discontinued operations, extraordinary items, and items charged or credited directly to shareholders' equity (paragraph 36). The amounts allocated to continuing operations is the tax effect of the pretax income or loss from continuing operations that occurred during the year, plus or minus income tax effects of (a) changes in circumstances that cause a change in judgment about the realization of deferred tax assets in future years (paragraph 26), (b) changes in tax laws or rates (paragraph 27), (c) changes in tax status (paragraph 28), and (d) tax-deductible dividends paid to shareholders (except as set forth in paragraph 36 for dividends paid on unallocated shares held by an employer stock ownership plan [ESOP] or any other stock compensation arrangement). The remainder is allocated to items other than continuing operations in accordance with the provisions of paragraph 38.

36. The tax effects of the following items occurring during the year are charged or credited directly to related components of shareholders' equity:

a. Adjustments of the opening balance of retained earnings for certain changes in accounting principles or a correction of an error.
b. Gains and losses included in comprehensive income but excluded from net income (for example, translation adjustments under Statement 52 and changes in the carrying amount of marketable securities under FASB Statement No. 12, Accounting for Certain Marketable Securities)

c. An increase or decrease in contributed capital (for example, deductible expenditures reported as a reduction of the proceeds from issuing capital stock)

d. An increase in the tax basis of assets acquired in a taxable business combination accounted for as a pooling of interests and for which a tax benefit is recognized at the date of the business combination

e. Expenses for employee stock options recognized differently for financial reporting and tax purposes (refer to paragraph 17 of APB Opinion No. 25, Accounting for Stock Issued to Employees)

f. Dividends that are paid on unallocated shares held by an ESOP and that are charged to retained earnings

g. Deductible temporary differences and carryforwards that existed at the date of a quasi reorganization (except as set forth in paragraph 39).

37. The tax benefit of an operating loss carryforward or carryback (other than those carryforwards referred to at the end of this paragraph) shall be reported in the same manner as the source of the income or loss in the current year and not in the same manner as (a) the source of the operating loss carryforward or taxes paid in a prior year or (b) the source of expected future income that will result in realization of a deferred tax asset for an operating loss carryforward from the current year. The only exceptions are as follows:

a. Tax effects of deductible temporary differences and carryforwards that existed at the date of a purchase business combination and for which a tax benefit is initially recognized in subsequent years in accordance with the provisions of paragraph 30

b. Tax effects of deductible temporary differences and carryforwards that are allocated to shareholders' equity in accordance with the provisions of paragraph 36 (items (c) and (e)-(g)).

38. If there is only one item other than continuing operations, the portion of income tax expense or benefit for the year that remains after the allocation to continuing operations is allocated to that item. If there are two or more items other than continuing operations, the amount shall be allocated among those other items in proportion to their individual effects on income tax expense or benefit for the year. When there are two or more items other than continuing operations, the sum of the separately calculated, individual effects of each item sometimes may not equal the amount of income tax expense or benefit for the year that remains after the allocation to continuing operations. In those circumstances, the procedures to allocate the remaining amount to items other than continuing operations are as follows:

a. Determine the effect on income tax expense or benefit for the year of the total net loss for all net loss items

b. Apportion the tax benefit determined in (a) ratably to each net loss item

c. Determine the amount that remains, that is, the difference between (1) the amount to be allocated to all items other than continuing operations and (2) the amount allocated to all net loss items

d. Apportion the tax expense determined in (c) ratably to each net gain item.

39. The tax benefits of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB No. 43, Chapter 7, “Capital Accounts,” ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years. The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by
paragraph 37 (without regard to the referenced exceptions) and then reclassified from retained earnings to contributed capital. Those enterprises should disclose (a) the date of the quasi reorganization, (b) the manner of reporting the tax benefits and that it differs from present accounting requirements for other enterprises and (c) the effect of those tax benefits on income from continuing operations, income before extraordinary items, and on net income (and on related per share amounts).

**Separate Financial Statements of a Subsidiary**

40. The consolidated amount of current and deferred tax expense for a group that files a consolidated tax return shall be allocated among the members of the group when those members issue separate financial statements. This Statement does not require a single allocation method. The method adopted, however, shall be systematic, rational, and consistent with the broad principles established by this Statement. A method that allocates current and deferred taxes to members of the group by applying this Statement to each member as if it were a separate taxpayer\(^\text{10}\) meets those criteria. Examples of methods that are not consistent with the broad principles established by this Statement include:

a. A method that allocates only current taxes payable to a member of the group that has taxable temporary differences

b. A method that allocates deferred taxes to a member of the group using a method fundamentally different from the asset and liability method described in this Statement (for example, the Opinion 11 deferred method)

c. A method that allocates no current or deferred tax expense to a member of the group that has taxable income because the consolidated group has no current or deferred tax expense.

\(^{10}\) In that situation, the sum of the amounts allocated to individual members of the group may not equal the consolidated amounts. That may also be the result when there are intercompany transactions between members of the consolidated group. The criteria are satisfied, nevertheless, after giving effect to the type of adjustments (including eliminations) normally present in preparing consolidated financial statements.

41. In a classified statement of financial position, an enterprise shall separate deferred tax liabilities and assets into a current amount and a noncurrent amount. Deferred tax liabilities and assets shall be classified as current or noncurrent based on the classification of the related asset or liability for financial reporting. A deferred tax liability or asset that is not related to an asset or liability for financial reporting (paragraph 15), including deferred tax assets related to carryforwards, shall be classified according to the expected reversal date of the temporary difference pursuant to FASB Statement No. 37, Balance Sheet Classification of Deferred Income Taxes. The valuation allowance for a particular tax jurisdiction shall be allocated between current and noncurrent deferred tax assets for that tax jurisdiction on a pro rata basis.

42. For a particular tax-paying component of an enterprise and within a particular tax jurisdiction, (a) all current deferred tax liabilities and assets shall be offset and presented as a single amount and (b) all noncurrent deferred tax liabilities and assets shall be offset and presented as a single amount. However, an enterprise shall not offset deferred tax liabilities and assets attributable to different tax-paying components of the enterprise or to different tax jurisdictions.

**Financial Statement Disclosure**

43. The components of the net deferred tax liability or asset recognized in an enterprise’s statement of financial position shall be disclosed as follows:

a. The total of all deferred tax liabilities measured in procedure (b) of paragraph 17
b. The total of all deferred tax assets measured in procedures (c) and (d) of paragraph 17

c. The total valuation allowance recognized for deferred tax assets determined in procedure (e) of paragraph 17.

The net change during the year in the total valuation allowance also shall be disclosed. A public enterprise shall disclose the approximate tax effect of each type of temporary difference and carryforward that gives rise to a significant portion of deferred tax liabilities and deferred tax assets (before allocation of valuation allowances). A nonpublic enterprise shall disclose the types of significant temporary differences and carryforwards but may omit disclosure of the tax effects of each type. A public enterprise that is not subject to income taxes because its income is taxed directly to its owners shall disclose that fact and the net difference between the tax bases and the reported amounts of the enterprise’s assets and liabilities.

44. The following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes for any of the areas addressed by Opinion 23 (as amended by this Statement) or for deposits in statutory reserve funds by U.S. steamship enterprises:

   a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
   b. The cumulative amount of each type of temporary difference
   c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable
   d. The amount of the deferred tax liability for temporary differences other than those in (c) above (that is, undistributed domestic earnings, the bad-debt reserve for tax purposes of a U.S. savings and loan association or other qualified thrift lender, the policyholders’ surplus of a life insurance enterprise, and the statutory reserve funds of a U.S. steamship enterprise) that is not recognized in accordance with the provisions of paragraphs 31 and 32.

45. The significant components of income tax expense attributable to continuing operations for each year presented shall be disclosed in the financial statements or notes thereto. Those components would include, for example:

   a. Current tax expense or benefit
   b. Deferred tax expense or benefit (exclusive of the effects of other components listed below)
   c. Investment tax credits
   d. Government grants (to the extent recognized as a reduction of income tax expense)
   e. The benefits of operating loss carryforwards
   f. Tax expense that results from allocating certain tax benefits either directly to contributed capital or to reduce goodwill or other noncurrent intangible assets of an acquired entity
   g. Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the enterprise
   h. Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years.

46. The amount of income tax expense or benefit allocated to continuing operations and the amounts separately allocated to other items (in accordance with the provisions of paragraphs 35-39) shall be disclosed for each year for which those items are presented.
47. A public enterprise shall disclose a reconciliation using percentages or dollar amounts of (a) the reported amount of income tax expense attributable to continuing operations for the year to (b) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The “statutory” tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation. If not otherwise evident from the disclosures required by this paragraph and paragraphs 43-46, all enterprises shall disclose the nature and effect of any other significant matters affecting comparability of information for all periods presented.

48. An enterprise shall disclose (a) the amounts and expiration dates of operating loss and tax credit carryforwards for tax purposes and (b) any portion of the valuation allowance for deferred tax assets for which subsequently recognized tax benefits will be allocated to reduce goodwill or other noncurrent intangible assets of an acquired entity or directly to contributed capital (paragraphs 30 and 36).

49. An entity that is a member of a group that files a consolidated tax return shall disclose in its separately issued financial statements:

   a. The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of any tax-related balances due to or from affiliates as of the date of each statement of financial position presented
   
   b. The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the disclosures in (a) above are presented.

Effective Date and Transition

50. This Statement shall be effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. Financial statements for any number of consecutive fiscal years before the effective date may be restated to conform to the provisions of this Statement. Initial application of this Statement shall be as of the beginning of an enterprise's fiscal year (that is, if the Statement is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods of that fiscal year shall be restated). Application of the requirements for recognition of a deferred tax liability or asset for a restated interim or annual period shall be based on the facts and circumstances as they existed at that prior date and without the benefit of hindsight.

51. The effect of initially applying this Statement shall be reported as the effect of a change in accounting principle in a manner similar to the cumulative effect of a change in accounting principle (APB Opinion No. 20, Accounting Changes, paragraph 20) except for initially recognized tax benefits of the type required by this Statement to be excluded from comprehensive income. If the earliest year restated is not presented in the financial statements, the beginning balance of retained earnings and, if necessary, any other components of shareholders' equity for the earliest year presented shall be adjusted for the effect of the restatement as of that date. Paragraph 30 addresses the manner of reporting acquired tax benefits initially recognized subsequent to a business combination and paragraph 36 identifies five items ((c)-(g)) for which tax benefits are excluded from comprehensive income and allocated directly to contributed capital or retained earnings. Pro forma effects of retroactive application (Opinion 20, paragraph 21) are not required if statements of earnings presented for prior years are not restated.

52. When initially presented, the financial statements for the year this Statement is first adopted shall disclose:
a. The effect, if any, of adopting this Statement on pretax income from continuing operations (for example, the effect of adjustments for prior purchase business combinations and for regulated enterprises) for the year of adoption if restated financial statements for the prior year are not presented.

b. The effect of any restatement on income from continuing operations, income before extraordinary items, and net income (and on related per share amounts) for each year for which restated financial statements are presented.

Prior Business Combinations

53. If financial statements for prior years are restated, all purchase business combinations that were consummated in those prior years shall be remeasured in accordance with the requirements of this Statement.

54. For a purchase business combination consummated prior to the beginning of the year for which this Statement is first applied, any balance remaining as of that date for goodwill or negative goodwill shall not be adjusted to equal the amount it would be if financial statements for the year of the combination and subsequent years were restated. However, except for leveraged leases and except as provided in paragraph 55, (a) remaining balances as of the date of initially applying this Statement for assets and liabilities acquired in that combination shall be adjusted from their net-of-tax amounts to their pretax amounts and (b) any differences between those adjusted remaining balances and their tax bases are temporary differences. A deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

55. If, for a particular business combination, determination of the adjustment for any or all of the assets and liabilities referred to in paragraph 54 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, none of the remaining balances of any assets and liabilities acquired in that combination shall be adjusted to pretax amounts, that is, all remaining amounts that were originally assigned on a net-of-tax basis pursuant to paragraph 89 of Opinion 16 shall not be adjusted. Any differences between those unadjusted remaining balances and their tax bases are temporary differences, and a deferred tax liability or asset shall be recognized for those temporary differences pursuant to the requirements of this Statement as of the beginning of the year for which this Statement is first applied.

56. The net effect of the adjustments required by paragraphs 54 and 55 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

Assets of Regulated Enterprises Reported on a Net-of-Tax or After-Tax Basis

57. Some regulated enterprises that apply Statement 71 have accounted for certain components of construction in progress on either a net-of-tax or after-tax basis, or both. Upon initial application of this Statement, those enterprises shall make appropriate adjustments required by this Statement to account for the net-of-tax and after-tax components of construction in progress as if the requirements of this Statement were applied to that construction in progress in all prior years. Except as provided in paragraph 58, the reported amount of plant in service at the beginning of the year for which this Statement is first applied shall be similarly adjusted.

58. If determination of the adjustment to plant in service referred to in paragraph 57 is impracticable, either because the necessary information is no longer available or because the cost to develop that information is excessive, any difference between the reported amount and the tax basis of that plant in service is a temporary difference, and a deferred tax liability shall be recognized for that temporary difference. If, as a result of an action by a regulator, it is probable that amounts required for settlement of that deferred tax liability will be recovered from customers through future rates, an asset and the related deferred tax liability for that additional temporary difference shall be recognized for that probable future revenue.

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59. The net effect of the adjustments required by paragraphs 57 and 58 shall be included in the effect of initially applying this Statement and reported in accordance with the provisions of paragraph 51.

289. GLOSSARY

**Carrybacks**

Deductions or credits that cannot be utilized on the tax return during a year that may be carried back to reduce taxable income or taxes payable in a prior year. An operating loss carryback is an excess of tax deductions over gross income in a year; a tax credit carryback is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried back and the length of the carryback period.

**Carryforwards**

Deductions or credits that cannot be utilized on the tax return during a year that may be carried forward to reduce taxable income or taxes payable in a future year. An operating loss carryforward is an excess of tax deductions over gross income in a year; a tax credit carryforward is the amount by which tax credits available for utilization exceed statutory limitations. Different tax jurisdictions have different rules about whether excess deductions or credits may be carried forward and the length of the carryforward period. The terms carryforward, operating loss carryforward, and tax credit carryforward refer to the amounts of those items, if any, reported in the tax return for the current year.

51. APB 28 provides the following guidance (However, note that FAS 109 supersedes APB Opinion Nos. 11 and 24 and amends APB Opinion No. 23);

19. In reporting interim financial information, income tax provisions should be determined under the procedures set forth in APB Opinion Nos. 11, 23, and 24. At the end of each interim period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.²

² Disclosure should be made of the reasons for significant variations in the customary relationship between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business (refer to FASB Statement No. 109, Accounting for Income Taxes, paragraph 47).

20. The tax effects of losses that arise in the early portion of a fiscal year should be recognized only when the tax benefits are expected to be (a) realized during the year or (b) recognizable as a deferred tax asset at the end of the year in accordance with the provisions of Statement 109. An established seasonal pattern of loss in early interim periods offset by income in later interim periods should constitute evidence that realization is more likely than not, unless other evidence indicates the established seasonal pattern will not prevail. The tax effects of losses incurred in early interim periods may be recognized in a later interim period of a fiscal year if their realization, although initially uncertain, later becomes more likely than not. When the tax effects of losses that arise in the early portions of a fiscal year are not recognized in that interim period, no tax provision should be made for income that arises in later interim periods until the tax effects of the previous interim losses are utilized.³ The tax effect of a valuation allowance expected to be necessary for a deferred tax asset at the end of the year for originating deductible temporary differences and carryforwards during the year should be included in the effective tax
rate. The effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related deferred tax asset in future years shall not be apportioned among interim periods through an adjustment of the effective tax rate but shall be recognized in the interim period in which the change occurs. The effects of new tax legislation shall not be recognized prior to enactment. The tax effect of a change in tax laws or rates on taxes currently payable or refundable for the current year shall be reflected after the effective dates prescribed in the statutes in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date of the new legislation. The effect of a change in tax laws or rates on a deferred tax liability or asset shall not be apportioned among interim periods through an adjustment of the annual effective tax rate. The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year shall be recognized as of the enactment date of the change as tax expense (benefit) for the current year.

3 The tax benefits of interim losses accounted for in this manner would not be reported as extraordinary items in the results of operations of the interim period.

OTHER SOURCES OF INFORMATION

52. Federal Income Tax Regulation Section 1.6662-4(d) provides the following guidance:

(d) Substantial authority (1) Effect of having substantial authority. If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see section 1.6662-4(g).)

(2) Substantial authority standard. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the “more likely than not” standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard (the standard which, if satisfied, generally will prevent imposition of the penalty under section 6662(b)(1) for negligence). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) Determination of whether substantial authority is present. (i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.

(ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is
accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Emerging Accounting Issues Working Group Position EI 86-1, True-up of Federal Income Taxes for Mutual Life Insurance Companies
- Emerging Accounting Issues Working Group Position EI 87-6, Accounting for the Impact of the Tax Reform Act of 1986
- Emerging Accounting Issues Working Group Position EI 93-4, Section 847 Deposits
- Emerging Accounting Issues Working Group Position EI 95-3, Equity Tax
- Emerging Accounting Issues Working Group Position EI 95-4, Equity Tax

Generally Accepted Accounting Principles
- FASB Statement No. 109, Accounting for Income Taxes
- FASB Interpretation No. 18, Accounting for Income Taxes in Interim Periods...an interpretation of APB Opinion No. 28
- Accounting Principles Board Opinion No. 2, Accounting for the “Investment Credit”
- Accounting Principles Board Opinion No. 4 (Amending No. 2), Accounting for the “Investment Credit”
- Accounting Principles Board Opinion No. 10, Omnibus Opinion—1966
- Accounting Principles Board Opinion No. 23, Accounting for Income Taxes—Special Areas
- Accounting Principles Board Opinion No. 28, Interim Financial Reporting
- FASB Technical Bulletin No. 79-9, Accounting for Interim Periods for Changes in Income Tax Rates
- FASB Technical Bulletin No. 82-1, Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases
- FASB Emerging Issues Task Force No. 91-8, Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax
- FASB Emerging Issues Task Force No. 92-8, *Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*

- FASB Emerging Issues Task Force No. 93-13, *Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations*

- FASB Emerging Issues Task Force No. 93-16, *Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23*

- FASB Emerging Issues Task Force No. 93-17, *Recognition of Deferred Tax Assets for a Parent Company’s Excess Tax Basis in the Stock of a Subsidiary That Is Accounted for as a Discontinued Operation*

- FASB Emerging Issues Task Force No. 94-10, *Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*

- FASB Emerging Issues Task Force No. 95-9, *Accounting for Tax Effects of Dividends in France in Accordance with FASB Statement No. 109*

- FASB Emerging Issues Task Force No. 95-10, *Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109*


- AICPA Accounting Interpretation, *Accounting for the Investment Credit: Accounting Interpretations of APB Opinion No. 4*

### Other Sources of Information

- Federal Income Tax Regulation Section 1.6662-4(d)
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Statutory Issue Paper No. 84

Quasi-reorganizations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Readjustments of additional paid in capital as if a reporting entity were reorganized but without the occurrence of a formal reorganization are considered to be quasi-reorganizations. Generally, quasi-reorganizations result in the elimination of a deficit retained earnings and establishment of a new basis for assets and liabilities. Current statutory accounting guidance does not address quasi-reorganizations.

2. GAAP addresses accounting for quasi-reorganizations in Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (ARB 43) and in Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus (ARB 46). Guidance is also provided in the Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210 and in the Staff Accounting Bulletins--Codification.

3. The purpose of this issue paper is to establish statutory accounting principles for quasi-reorganizations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization shall be permitted only if the criteria in both subparagraphs 4 a and 4 b and either subparagraph 4 c or 4 d are met:

   a. Such restatement is approved in writing by the domiciliary Commissioner;

   b. An 80% or greater change in the ultimate ownership of the reporting entity has occurred within six months prior to approval of such restatement;

   c. A new business plan has been adopted that results in a substantive change in the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations;

   d. The reporting entity is a shell company with no existing operations, inforce policies or outstanding claims.

5. As defined in Issue Paper No. 72 - Statutory Surplus, unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. In no instance shall restatement result in the unassigned funds (surplus) account being greater than zero or the gross paid in and contributed surplus account being less than zero immediately following the restatement. Total surplus as regards policyholders shall remain unchanged following such restatement. The following components of unassigned funds (surplus) shall be considered in determining the amount available for restatement:

   a. Net Income
b. Effect of Exchange Rate Fluctuations
c. Dividends to Stockholders
d. Change in Accounting Principles
e. Correction of an Error
f. Stock Issuance Expenses

6. The assets and liabilities of the reporting entity shall continue to be carried at historical cost or other value required under statutory accounting principles. No adjustments to assets or liabilities shall be made to reflect the effect of a quasi-reorganization.

7. The impact of the restatement shall be disclosed in the notes to financial statements as long as financial statements for the period of the reorganization are presented. The effective date of the reorganization shall be disclosed for a period of ten years following the reorganization.

DISCUSSION

8. Current statutory accounting guidance does not address quasi-reorganizations. Quasi-reorganization is a concept in GAAP that is intended to apply in very limited situations. The effect in GAAP accounting for a quasi-reorganization is to eliminate negative retained earnings by capitalizing negative retained earnings to paid-in capital; and, to adjust net assets downward, but not upward, to fair value (i.e., individual assets may be written up or liabilities reduced as appropriate, but only to the extent that the aggregate net adjustment does not increase net assets). Quasi-reorganizations are initiated for various purposes, including to facilitate the payment of dividends by a reporting entity that is currently profitable but has negative retained earnings prior to the quasi-reorganization.

9. The conclusion permits the restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization in certain limited circumstances. The conclusion also requires that total surplus as regards policyholders remain unchanged following such restatement and that the assets and liabilities of the reporting entity be carried at historical cost or other value required under statutory accounting principles and not revalued pursuant to a quasi-reorganization. This conclusion allows regulatory flexibility in instances where there has been a change in the ultimate ownership, the business plan of the reporting entity has substantively changed the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations, or the reporting entity is a shell company with no existing operations or outstanding policies. This conclusion is consistent with the regulatory need for consistent data on a year-to-year basis in order to monitor performance of insurance enterprises on a continuing basis. The conclusion is also consistent with the requirement to retain the historical basis of reporting following a business combination as discussed in Issue Paper No. 68 - Business Combinations and Goodwill.

10. This issue paper adopts Chapter 7, Section A of ARB 43 with a modification to permit restatement of gross paid in and contributed surplus and unassigned funds (surplus) only in certain limited circumstances. In addition, this issue paper requires that the assets and liabilities of the reporting entity continue to be carried at historical cost or other value required under statutory accounting principles and that no changes to total surplus as regards policyholders are to be made to reflect the effect of a quasi-reorganization. This issue paper adopts ARB 46 with modification to require disclosure of the impact of the restatement in the notes to financial statements as long as financial statements for the period of reorganization are presented.
11. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts, as follows:

**Conservatism**

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

**Consistency**

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

**Drafting Notes/Comments**

None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

None

**Generally Accepted Accounting Principles**

12. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

Chapter 7: CAPITAL ACCOUNTS
Section A -- Quasi-Reorganization or Corporate Readjustment

(Amplification of Institute Rule No. 2 of 1934)

1. A rule was adopted by the Institute in 1934 which read as follows:

“Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization.”

1 See chapter 1A, paragraph 2.

2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred
to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

Procedure in Readjustment

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum probable losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

Procedure after Readjustment

9. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.
11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

13. ARB 46 provides the following guidance (only the pertinent excerpts are included below):

1. Paragraph 10 of Chapter 7(a), Quasi-Reorganization or Corporate Readjustment, of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, reads as follows:

   After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

OTHER SOURCES OF INFORMATION

14. Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 210 provides the following guidance (only the pertinent excerpts are included below):

210 Quasi-Reorganization ASR 25:

Inquiry has been made from time to time as to the conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without the creation of new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization. It has been the Commission's view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

1. Earned surplus, as of the date selected, is exhausted;
2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;
4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also implicit in a procedure of this kind that it is not to be employed recurrently but only
under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.

In the case of the quasi-reorganization of a parent company, it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

15. The Securities and Exchange Commission Staff Accounting Bulletins--Codification provides the following guidance (only the pertinent excerpts are included below):

S. Quasi-Reorganization

Facts:

As a consequence of significant operating losses and/or recent write-downs of property, plant and equipment, a company’s financial statements reflect an accumulated deficit. The company desires to eliminate the deficit by reclassifying amounts from paid-in-capital. In addition, the company anticipates adopting a discretionary change in accounting principles that will be recorded as a cumulative-effect type of accounting change. The recording of the cumulative effect will have the result of increasing the company’s retained earnings.

1 Discretionary accounting changes require the filing of a preferability letter by the registrant’s independent accountant pursuant to Item 601 of Regulation S-K and Rule 10-01(b)(6) of Regulation S-X, 17 CFR §§229.601 and 210.10-01(b)(6), respectively.

Question 1:

May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210 of the Codification of Financial Reporting Policies for a quasi-reorganization?

2 Accounting Series Release No. 25 (May 29, 1941).

Interpretive Response:

No. The staff believes a deficit reclassification of any nature is considered to be a quasi-reorganization. As such, a company may not reclassify or eliminate a deficit in retained earnings unless all requisite conditions set forth in Section 210 for a quasi-reorganization are satisfied.

3 Section 210 indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings:

(1) Earned surplus, as of the date selected, is exhausted;
(2) Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions;
(4) The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings--namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital
Question 2:

Must the company implement the discretionary change in accounting principle simultaneously with the quasi-reorganization or may it adopt the change after the quasi-reorganization has been effected?

Interpretive Response:

The staff has taken the position that the company should adopt the anticipated accounting change prior to or as an integral part of the quasi-reorganization. Any such accounting change should be effected by following generally accepted accounting principles with respect to the change.5

Chapter 7A of Accounting Research Bulletin (ARB) No. 43 indicates that, following a quasi-reorganization, a “company’s accounting should be substantially similar to that appropriate for a new company.” The staff believes that implicit in this “fresh-start” concept is the need for the company’s accounting principles in place at the time of the quasi-reorganization to be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization.6 Chapter 7A of ARB No. 43 states, in part, “... in general, assets should be carried forward as of the date of the readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the Company thereafter (emphasis added).”

In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within 12 months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.7

7 Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.
Question 3:
In connection with a quasi-reorganization, may there be a write-up of net assets?

Interpretive Response:
No. The staff believes that increases in the recorded values of specific assets (or reductions in liabilities) to fair value are appropriate providing such adjustments are factually supportable, however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant. (Added by SAB No. 78, 8/25/88.)

Question 4:
The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210. Assume a company has adopted Statement of Financial Accounting Standards ("SFAS") No. 96, has satisfied all the requisite conditions of Section 210, and has eliminated a deficit in retained earnings by a concurrent reduction in paid-in capital, but did not need to restate assets and liabilities by a charge to capital because assets and liabilities were already stated as fair values. How should the company reflect the tax benefits of operating loss or tax credit carryforwards for financial reporting purposes that existed as of the date of the quasi-reorganization when such tax benefits are subsequently recognized for financial reporting purposes?

Interpretive Response:
The staff believes SFAS No. 96 requires that any subsequently recognized tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization be reported as a direct addition to paid-in capital. The staff believes that this position is consistent with the "new company" or "fresh-start" concept embodied in Section 210, and in existing accounting literature regarding quasi-reorganizations, and with the FASB staff's justification for such a position when they stated that a "new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date.

8 Supra Note 3.

9 Section 210 discusses the "conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without creation of new corporate entity and without intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization." It further indicates that "it is implicit in a procedure of this kind that it is not to be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new corporation, particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses."[Emphasis added.]

10 Special Report: A Guide to Implementation of Statement 96 on Accounting for Income Taxes; Financial Accounting Standards Board (March 1989); question 26, page 36 and 37, states in part: "ARB No. 43, Chapter 7, "Capital Accounts," states that after a quasi reorganization, the enterprise's accounting should be substantially similar to that appropriate for a new enterprise. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward for financial reporting that existed at the date of a quasi reorganization should not be included in the determination of income of the "new" enterprise, regardless of whether losses that gave rise to an operating loss carryforward were charged to income prior to the quasi
reorganization or directly to contributed capital as part of the quasi reorganization. A new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."

The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event.11 This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 54 of SFAS No. 96 for the tax benefits of tax carryforward items.12 Therefore, even though the only effect of a quasi-reorganization is the elimination of a deficit in retained earnings because assets and liabilities are already stated at fair values and the revaluation of assets and liabilities is unnecessary (or a write up of net assets is prohibited as indicated in the interpretive response to question 3 above), subsequently recognized tax benefits of operating loss or tax credit carryforward items should be recorded as a direct addition to paid-in capital.

11 SFAS No. 96 (December 1987); paragraph 54, states: “Some quasi reorganization involve only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital. For that type of reorganization, subsequent recognition of the tax benefit of a prior operating loss or tax credit carryforward for financial reporting is reported as required by paragraph 52 and then reclassified from retained earnings to contributed capital.” [Emphasis added.] Also, Supra Note 10.

12 The first sentence of paragraph 54 of SFAS No. 96 states: “The tax benefit of an operating loss or tax credit carryforward for financial reporting as of the date of a quasi-reorganization as defined and contemplated (involving write-offs directly to contributed capital) in ARB No. 43, Chapter 7, “Capital Accounts,” is reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years”.

Question 5:

If a company had previously recorded a quasi-reorganization that only resulted in the elimination of a deficit in retained earnings, may the company reverse such entry and “undo” its quasi-reorganization?

Interpretive Response:

No. The staff believes APB Opinion No. 20 would preclude such a change in accounting. It states: “a method of accounting that was previously adopted for a type of transaction or event which is being terminated or which was a single, nonrecurring event in the past should not be changed.” [Emphasis added]13

13 Accounting Principles Board Opinion No. 20 (July 1971); paragraph 16.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 68 - Business Combinations and Goodwill
- Issue Paper No. 72 - Statutory Surplus
Generally Accepted Accounting Principles
- Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 7, Section A, Quasi-reorganization or Corporate Readjustment
- Accounting Research Bulletin No. 46, *Discontinuance of Dating Earned Surplus*

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210
- Securities and Exchange Commission Staff Accounting Bulletins - Codification, Topic 5, S
Statutory Issue Paper No. 85

Derivative Instruments

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Chapter 8 of the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals) contains guidance on accounting for derivative instruments. This guidance provides two alternatives for accounting for derivative instruments: (a) Hedge accounting, or (b) Immediate recognition (mark to market) accounting. Specific accounting guidance for Income Generation Transactions was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996.

2. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. To the extent that specific accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. The key GAAP accounting literature applicable to derivatives, which is primarily addressed in FASB Statement No. 80, Accounting for Futures Contracts (FAS 80), FASB Statement No. 52, Foreign Currency Translation (FAS 52), and FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions (EITF 84-36), is based on hedge accounting for futures and foreign exchange contracts, settlement accounting for interest rate swaps and mark to market accounting.

3. The purpose of this issue paper is to establish statutory accounting principles for derivative instruments (hereinafter referred to as derivatives), that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper adopts the Derivative Instruments guidance of Chapter 8 of the Life/A&H and P&C Accounting Practices and Procedures Manuals. Paragraphs 6 through 10 herein summarize the key provisions of the guidance. Derivatives shall be defined as swaps, options, forwards, futures, caps, floors, and collars. The following are general definitions for these derivative instruments:

a. Swaps: Swaps are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

b. Options: Options are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;
c. Forwards: Forward contracts are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

d. Futures: Futures are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

e. Caps: Caps are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

f. Floors: Floors are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

g. Collars: A collar is a combination of a cap and a floor (one purchased and one written). A collar fixes the rate between two levels (the strike prices of the cap and the floor).

5. To the extent a derivative is in an asset position, the instrument meets the definition of an asset as defined in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets and, subject to certain limitations, meets the criteria for an admitted asset as specified in that same paper. To the extent a derivative is in a liability position, the instrument meets the definition of a liability as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No 5).

6. Hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce: (a) the risk of a change in the value, yield, price, cash flow, or quantity of assets or liabilities which the reporting entity has acquired or incurred or anticipates acquiring or incurring, or (b) the currency exchange rate risk or the degree of exposure as to assets or liabilities which a reporting entity has acquired or incurred or anticipates acquiring or incurring. Derivatives used by reporting entities in hedging activities shall be accounted for in a manner consistent with the item hedged. For example, if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost. If the item being hedged is accounted for at market value, the hedging derivative also is accounted for at market value.

7. To qualify for hedge accounting, the derivative shall be designated as a hedge of a specific asset, liability, or anticipated transaction. The specific asset, liability, or anticipated transaction to be hedged must expose the reporting entity to a risk and the designated derivative transaction must reduce that exposure. Examples of items that expose the reporting entity to risk include change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities, or future cash
flows which a reporting entity has acquired or incurred, or anticipates acquiring or incurring. To satisfy the condition of risk reduction, the reporting entity shall demonstrate how the derivative instrument reduces risk by using an appropriate method. There are a variety of methods available that can be used to demonstrate risk reduction, including methods which analyze the correlation of gains and losses on the derivative in relation to the losses and gains on the hedged asset, liability, or future cash flow. Included in the concept of hedge accounting is the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue.

8. Reporting entities shall set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and apply those criteria in the ongoing assessment of actual hedge results. For example, if correlation is used to measure the effectiveness of a hedge, high correlation of changes in the fair value of the derivative and the fair value of the item being hedged should be probable so that such changes will substantially offset each other throughout the hedge period. Other methods used should demonstrate a similar result to be considered effective. Also, at the inception of the hedge, formal documentation of the hedging instrument and the related hedged item, including the nature of the risk being hedged, shall be drafted and retained for future reference. Upon termination of the derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. If the item being hedged is subject to IMR, the gain or loss on the hedging derivative instrument shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss currently in earnings.

9. Alternatively, reporting entities may mark derivatives to market (immediate recognition method) from inception to termination. Generally, this alternative is used where it is impractical to allocate gains and losses to specific hedged assets, liabilities, or future cash flows. This alternative shall be used for derivatives that are entered into for other than hedging purposes, when a portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities, or for derivatives that are not specifically addressed elsewhere in this guidance.

10. Other than hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. Unrealized gains and losses cannot be deferred when categorized as other than hedging.

11. The reporting entity’s choice between accounting methods discussed in paragraphs 6 through 9 (hedge versus immediate recognition) shall be applied consistently for each individual instrument over the life of the derivative. A change in method shall be justified by a significant change in circumstance.

**Income Generation Transactions**

12. Income generation transactions are defined as derivative instruments written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock which it already owns).

13. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be “covered” (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.
14. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

15. The principal features of income generation transactions are:
   a. Premium received is initially recorded as a deferred liability;
   b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., bonds);
   c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;
   d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

16. The principal features of written fixed income covered call options are:
   a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract;
   b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;
   c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;
   d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset’s book value, the asset shall be evaluated for write down or disclosure treatment in accordance with Issue Paper No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income shall be considered.
17. Written fixed income covered call options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable. (3)</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

1. A general statement will be added to the instructions stating that reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.


3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.
18. The principal features of written covered put options are:
   a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
   b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
   c. As with covered call writing, reporting entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy;

19. Written covered put options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST VALUED AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Notes:
1. Reporting entities writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
20. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the reporting entity is selling off possible excess interest/income, the value of the covering asset is not relevant;

b. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract’s maturity.

21. Written fixed income caps and floors shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if within 1 year of maturity.)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

22. Examples of accounting and presentation based on varying assumptions can be found in the October 1, 1996 minutes of the Accounting Practices and Procedures (EX4) Task Force.

**Disclosure Requirements**

23. Reporting entities shall disclose the following for all derivative contracts outstanding:

a. Disclosures by category of instrument:

   i. Notional or contract amounts;
   ii. Carrying and fair values;
   iii. A description of the accounting policies for derivatives;
iv. A discussion of the market risk, credit risk, and cash requirements of the derivative instruments.

b. General Disclosures:
   i. A description of the reporting entity’s objectives for holding or issuing the derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivatives used;
   ii. A description of how each category of derivative is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives held or issued, and when recognized, where those instruments and related gains and losses are reported.

24. Reporting entities shall disclose the following for derivatives held for other than hedging purposes:
   a. Average fair value of the derivative instruments during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
   b. Net gains or losses disaggregated by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

25. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

DISCUSSION

26. The Summary Conclusion adopts the aforementioned sections of current statutory accounting principles (Chapter 8) for derivatives including insurance futures and insurance futures options. These principles are consistent with the Statement of Concepts because they provide recognition of derivatives as assets or liabilities, and recognition of income (gains) or expense (losses) based on how the reporting entity uses the derivative to reduce risk related to an existing exposure. It also provides a consistent approach to accounting for the many types of derivatives currently available to reporting entities.

27. This issue paper clarifies that the immediate recognition method of accounting (mark to market) shall be applied in situations where a reporting entity enters into a derivative for other than hedging purposes, when a portfolio has been hedged, or for derivatives that are not specifically addressed elsewhere in this guidance. Other than hedging is defined as any transaction which does not qualify for hedge accounting, including active derivatives trading by a reporting entity who enters into derivatives for purposes of generating profits on short-term differences in market movements and not for risk reduction purposes. This clarification is added so that unrealized gains and losses, particularly losses, cannot be deferred when categorized as other than hedging. This is consistent with the conservatism concept in the Statement of Concepts. Further, the immediate recognition method of accounting is not precluded from being utilized in situations where the derivative qualifies for hedge accounting.

28. This issue paper also provides that the determination of hedge accounting or immediate recognition accounting shall be made for each individual instrument. A reporting entity may utilize immediate recognition accounting for certain derivatives within a category and hedge accounting for other derivatives within that same category. This is a change from current statutory accounting principles, which provide that the categories to which immediate recognition accounting treatment is applied should be consistent from period to period.
29. While there is a separate section in the current statutory accounting guidance for insurance futures and related instruments, the accounting is similar to that of other derivatives. Therefore, the conclusion does not differentiate futures or options accounting from insurance futures or insurance futures options accounting, however, the distinctions in current statutory guidance in accounting and reporting for these instruments are adopted. The separate section for insurance futures and insurance futures options was incorporated into the current Life/A&H and P&C Accounting Practices & Procedures Manuals because insurance futures are viewed by insurance regulators as insurance-related transactions and not as investment-related transactions. As a result, insurance futures and insurance futures options are reported on Schedule DC and not Schedule DB as for other non-insurance derivatives. Also, income related to insurance futures and insurance futures options is reported as an aggregate write-in for miscellaneous income not as investment income and any asset is recorded as an aggregate write-in for other than invested assets.

30. Current statutory accounting does not specifically address settlement accounting for interest rate swaps. Under certain conditions (as set forth in EITF Issue No. 84-36), GAAP permits settlement accounting for interest rate swaps. Therefore, EITF Issue Nos. 84-36 and 84-7 are adopted.

31. Under settlement accounting, periodic net cash settlements under the swap agreement are recognized in income when they accrue. Settlement accounting is considered a conservative approach, and in many instances, produces an accounting result which is similar to hedge accounting. Such accounting is widely accepted in practice and provides an accounting approach that is consistent with the purpose of entering into such an instrument; that is, to change the interest rate characteristics of the balance sheet item to which it is matched. When this issue paper refers to hedge accounting, it encompasses the notion of settlement accounting for interest rate swaps that are matched through designation with an asset or a liability on the balance sheet.

32. The accounting and reporting for derivative instruments used for income generation is intended to meet (1) regulatory needs focusing on company and industry solvency, (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

   a. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset;

   b. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging;

   c. The approach looks to the substance of the transactions involved:

      i. It matches the accounting of the derivative with the accounting of the covering asset or underlying interest;

      ii. It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces;

      iii. It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.
33. Under GAAP, although there is no authoritative accounting guidance for written covered options, written options are generally reported at fair value with changes in fair value reported in earnings because written options do not qualify for hedge accounting except to the extent of the premium received. However, certain GAAP practice considers that the writer will never sustain a loss on a written covered option if the strike price of the option exceeds the book value of the covered asset, and the writer intends to deliver the covered asset if the option is exercised instead of settling the option in cash. Under these circumstances, certain GAAP practice includes carrying the option at cost with the option premium recorded in income when the options is exercised, at its expiration, or, if designated as a hedge, deferred as an adjustment of the cost of the covered asset.

34. Based on the inconsistency in the accounting results and the uncertainty surrounding the GAAP accounting for derivatives, other GAAP pronouncements are rejected as discussed below. Although some view GAAP accounting for derivatives as more conservative because of the stricter requirements of hedge accounting, statutory requirements are sufficiently restricted so that they are consistent with the conservatism and recognition principles of the Statement of Concepts.

35. GAAP is not applied uniformly for different types of derivatives because there is no comprehensive authoritative accounting guidance. Under GAAP, there are different rules for different derivatives and there are different rules for different uses of derivatives. To the extent that specific GAAP accounting guidance does not exist for some derivatives, practice is based on analogy to the literature that does exist for other derivatives. Also, the accounting for futures, forwards, options and swaps differs depending on whether these instruments are denominated in a domestic currency or in a foreign currency. The guidance in FAS 80 is used for futures contracts, and, by analogy, for certain other derivatives when they are denominated in the domestic currency of the entity. Although certain of the notions of designation, risk reduction and correlation from FAS 80 are incorporated in this paper, FAS 80 is rejected since statutory accounting principles as clarified herein provide sufficient guidance for hedge accounting. Consistent with Issue Paper No. 81 - Foreign Currency Transactions and Translations, FAS 52 is rejected for reasons set forth in that paper. However, some of the elements of FAS 52 have been incorporated into this paper. The guidance in FAS 52 generally is applied when these instruments are denominated in a foreign currency that is not the functional currency of the entity. Also, this issue paper rejects the following GAAP pronouncements, which are limited to very narrow situations for which the broad accounting described in this issue paper is sufficient (such pronouncements are not reproduced herein due to length and limited scope):

- FASB Emerging Issues Task Force No. 84-14, Deferred Interest Rate Setting
- FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions
- FASB Emerging Issues Task Force Issue No. 87-2, New Present Value Method of Valuing Speculative Foreign Exchange Contracts
- FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps
- FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options
- FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks
- FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions
- FASB Emerging Issues Task Force Issue No. 95-11, Accounting for Derivative Instruments Containing both a Written Option-Based Component and a Forward-Based Component
- FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115
36. Because of inconsistencies in the accounting for derivatives, the FASB has been involved in a long-term project to address the accounting for off-balance-sheet financial instruments and is currently involved in deliberations to change the current accounting for derivatives under GAAP.

**Disclosure Requirements**

37. The disclosures required by FAS 105 cover financial instruments with off-balance-sheet risk of accounting loss. The scope includes derivatives with off-balance sheet risk as well as other types of financial instruments. FAS 105 is adopted for all financial instruments with off-balance-sheet risk with the following modifications:

a. The disclosures required in paragraph 17 shall distinguish between derivatives entered into for hedging purposes and for other than hedging purposes;

b. Paragraph 19 is rejected. It addresses voluntary disclosures not required by this issue paper.

38. FAS 119 extends the requirements of FAS 105 to all derivatives and requires additional disclosures. FAS 119 is adopted with the following modifications:

a. The disclosures required in paragraph 8 shall distinguish between derivatives entered into for hedging purposes and for other than hedging purposes;

b. The disclosures required for trading derivatives by paragraph 10 shall be required for derivatives entered into for other than hedging purposes;

c. Only the required disclosures in FAS 119 are adopted by this issue paper not the voluntary quantitative or qualitative disclosures. Therefore, paragraphs 12 and 13 are rejected.

39. Current statutory guidance provides specific information relating to derivatives in Schedules DB and DC of the Annual Statement. GAAP requires disclosures about derivative financial instruments in accordance with FAS 119. FAS 119 requires a distinction between derivatives used for trading and other than trading purposes for purposes of disclosure in the notes to the financial statements. Other information is required in the notes, such as notional amounts, carrying and fair values by category of derivative, a description of the accounting policies for derivatives, market and credit risk as well as other optional quantitative and qualitative information. Most of the required disclosures can be derived from information provided on Schedules DB and DC of the Annual Statement. The disclosure requirements are not intended to provide duplicative presentation in the annual statement filings but are required in those circumstances where the accompanying exhibits which contain certain required disclosures are not part of the reporting entity’s financial statements (e.g., annual audit report). The disclosures required by FAS 119 are modified in that the classification of the disclosures shall be based on the accounting methodology adopted for the instrument based on hedge accounting or immediate recognition accounting, rather than on the notions of trading and other than trading in FAS 119.

**Drafting Notes**

- The accounting for investments in mortgage backed securities, collateralized mortgage obligations, real estate mortgage investment conduits, interest-only securities and principal-only securities, among others, is primarily addressed in Issue Paper No. 43 - Loan-backed and Structured Securities.

- The Invested Asset Working Group of the Valuation of Securities (EX4) Task Force met on June 2, 1996 and considered four derivatives projects. In October of 1996, the Blanks Task Force will consider incorporation of certain changes to current derivatives guidance, a summary of which is provided in paragraph 49.
RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting
40. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contains the following guidance relating to derivative instruments:

Derivative Instruments

Derivative instruments are reported in Schedule DB of the annual statement using the definitions below. Specific accounting procedures for each derivative instrument will depend on the definition below that best describes the instrument. State investment laws and regulations should be consulted for applicable limitations on the use of derivative instruments.

Definitions:

"Underlying Interest" means the asset(s), liability(ies) or other interest(s) underlying a Derivative Instrument, including, but not limited to, any one or more securities, currencies, rates, indices, commodities, Derivative Instruments or other financial market instruments.

"Option" means an agreement giving the buyer the right to buy or receive, sell or deliver, enter into, extend or terminate, or effect a cash settlement based on the actual or expected price level, performance or value of, one or more Underlying Interests.

"Cap" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a reference price, level, performance or value of one or more Underlying Interests exceeds a predetermined number, sometimes called the strike/cap rate or price.

"Floor" means an agreement obligating the seller to make payments to the buyer, each payment under which is based on the amount, if any, that a predetermined number, sometimes called the strike/floor rate or price, exceeds a reference price, level, performance or value of one or more Underlying Interests.

"Collar" means an agreement to receive payments as the buyer of an Option, Cap or Floor and to make payments as the seller of a different Option, Cap or Floor.

"Swap" means an agreement to exchange or net payments at one or more times based on the actual or expected price, level, performance or value of one or more Underlying Interests.

"Forward" means an agreement (other than a Futures) to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

"Futures" means an agreement traded on an exchange, board of trade or contract market, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance or value of, one or more Underlying Interests.

General Accounting Guidance:

Hedging:
Derivative instruments used by insurers in hedging transactions should be accounted for in a manner consistent with the item hedged prior to termination. Upon termination, the gains and losses from the derivative instrument will adjust the basis of the hedged item.
Alternatively, companies may mark derivative instruments of a given type to market from inception to termination with gains and losses recognized currently. Generally this alternative is used where it is impractical to allocate gains and losses to specific hedged assets or liabilities. The accounting treatment and categories to which this accounting treatment is applied should be consistent from period to period. However, derivative instruments hedging items which are subject to IMR will follow hedge accounting (amortized book value) while the instruments are still open and that the gains/losses will be subject to IMR upon termination.

For a derivative instrument to qualify for hedge accounting, the item to be hedged must expose the company to a risk and the designated derivative transaction must reduce that exposure. Examples include the risk of a change in the value, yield, price, cash flow, or quantity of, or degree of exposure with respect to assets, liabilities or future cash flows which an insurer has acquired or incurred, or anticipates acquiring or incurring.

A company should set specific criteria at the inception of the hedge as to what will be considered effective in measuring the hedge and then apply those criteria in the ongoing assessment based on actual hedge results. Insurers should account for a derivative instrument at market value if it ceases to be “effective” as a hedge and recognize the gain or loss currently to the extent it has not been offset by the effects of changes on the hedged item.

Documentation Guidance:

An insurer shall maintain documentation and records relating to derivative instruments opened during the year, instruments outstanding at year end, and instruments terminated during the year. Minimum required documentation is as follows:

(a) For derivative instruments opened during the year:

(1) A description, for each instrument, of the purpose of the transaction, including:

- A brief description of the assets and/or liabilities hedged by the instrument.
- A brief description of the manner in which the instrument reduces risk.
- A reference to the company’s hedge program under which such transaction is internally authorized.

(2) Signature of approval, for each instrument, by person(s) authorized, either by the insurer’s board of directors or a committee authorized by the board, to approve such transactions.

(3) A description, for each instrument, of the nature of the transaction, including:

- The date of the transaction.
- A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
- Number of contracts or notional amount.
- Date of maturity, expiry or settlement.
- Strike price, rate or index, (opening price for futures contracts).
- Counterparty, or exchange on which the transaction was traded.
- Cost or consideration received, if any, for opening transaction.
(4) A description of the company methodology used to verify that opening transactions do not exceed limitations promulgated by the insurers state of domicile.

(b) For derivative instruments terminated during the year:

(1) Signature of approval, for each instrument, by person(s) authorized, either by the insurer's board of directors or a committee authorized by the board, to approve such transactions.

(2) A description, for each instrument, of the nature of the transaction, including:

- The date of the transaction.
- A complete and accurate description of the specific derivative instrument, including description of the underlying securities, currencies, rates, indices, commodities, derivative instruments, or other financial market instruments.
- Number of contracts or notional amount.
- Date of maturity, expiry or settlement.
- Strike price, rate or index, (termination price for futures contracts).
- Counterparty, or exchange on which the transaction was traded.
- Consideration paid or received, if any, on termination.

(3) Description of company methodology to verify that derivative instruments were effective hedges.

(4) Identification of any derivative instruments that ceased to be effective as hedges.

(c) For derivative instruments open at year end:

(1) A description of the methodology used to verify the continued effectiveness of hedges.

(2) An identification of any derivative instruments which have ceased to be effective as hedges.

(3) A description of company methodology to determine market values of derivative instruments.

(4) Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Specific Accounting Procedures for Derivative Instruments

(a) Call and Put Options, Caps, and Floors:

(1) Accounting at Date of Acquisition (purchase) or Issuance (written):

The premium paid or received for purchasing or writing a call option, put option, cap or floor shall be carried as an asset (purchase) or liability (written) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).
(2) Statement Value:

- Open derivative instruments hedging items carried at amortized cost (where company does not elect to recognize gain/loss currently):
  - Options, caps and floors purchased or written shall be valued at amortized cost in a manner consistent with the hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities, the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments, the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument, it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent they ceased to be effective hedges.
- Open derivative instruments hedging items carried at market value, (where company does not elect to recognize gain/loss currently):
  - Options, caps or floors purchased or written shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
  - Usually this will result in unrealized gain/loss treatment with adjustment to surplus.
For hedges where the cost of the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

For hedges of items which are not subject to IMR, options, caps or floors purchased or written shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

For hedges of items which are subject to IMR, options, caps and floors purchased or written shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

Where the cost of the derivative instrument is not combined with the hedged item:

Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2;

Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

Exercise of an Option: The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.
• Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

• Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

• For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(b) Swaps, Collars and Forwards:

An interest rate swap is a contractual agreement between two parties to exchange interest rate payments (usually fixed for variable) based on a specified amount of underlying assets or liabilities (known as the notional amount) for a specified period. The swap does not involve an exchange of principal. The result of these transactions is to transform payments from a variable rate to a fixed rate, from a fixed rate to a variable rate or from one variable rate index to another variable rate index.

Interest rate swaps have historically been entered into for the purpose of lowering borrowing costs, obtaining otherwise unavailable financing terms, and/or improving asset and liability management through a reduction of an entity’s exposure to interest rate risk. Banks and brokers will enter into an interest rate swap with an interested party before a swap partner is found, creating a swap portfolio. This activity allows the corporation that desires a swap transaction immediate access to the market. This secondary market also allows a swap participant a vehicle to unwind or reverse swap positions it no longer wants or receive cash if the position to be disposed of is favorable in relation to the current market.

While swaps may involve the trading of interest on liabilities or assets, insurance industry members have used swaps to match return on assets to contract obligations. Insurers also have acted as an intermediary or broker in the process of arranging a swap. Swaps may involve long periods of time and significant amounts of interest on substantial notional amounts. Unmatched or naked swaps are sometimes written where no underlying asset or liability exists.

The risk to the parties of a swap agreement is reduced by the fact that no transfer of principal is involved. The cash exchanged between the parties is usually the net interest differential only.

In general, interest rate swaps are off-balance-sheet items, disclosed in the footnotes to the financial statements. With respect to the income statement, swap payments flow through other income or expense. The recording of capital gains or losses arises only in the event that one party to a swap agreement defaults. In such a circumstance, the defaulting party is required to make a lump sum payment to the other party in exchange for the release of their obligations under the contract. The amount of the lump sum payment represents the capital gain/loss recorded by each party.
(1) **Accounting at Date of Opening Position:**

Any premium paid or received at date of opening shall be carried as an asset (paid) or liability (received) on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability).

(2) **Statement Value:**

- Open derivative instruments hedging items carried at amortized cost (where the company does not elect to recognize gain/loss currently):
  - Swaps, collars and forwards shall be valued at amortized cost in a manner consistent with hedged item.
  - The amortization period and methods used should in general result in a constant effective yield over the life of the hedged item or program. (For floating rate securities the estimated effective yield should be based on the current rate so the changes in yields attributable to changes in interest rates will be recognized in the period of change.) Specific treatment includes:
    - Holdings in derivative instruments purchased or written within a year of maturity or expiry need not be amortized;
    - For anticipatory hedges, the derivative instrument may be carried at cost until the anticipated hedged transaction occurs or it is determined that the hedge was not effective;
    - For other derivative instruments the amortization period is usually from date of acquisition (issuance) of the derivative instrument to maturity of the hedged item or program.
  - For hedges where the cost of the derivative instrument is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
  - If during the life of the derivative instrument it is no longer effective as a hedge, valuation at amortized cost ceases and the derivative instrument shall be valued at its current market value (marked to market) with gains and losses recognized as adjustments to surplus to the extent that it ceased to be an effective hedge.
- Open derivative instruments hedging items carried at market value (where company does not elect to recognize gain/loss currently):
  - Swaps, collars or forwards shall be valued at current market value (marked to market) with changes in market value recognized currently consistent with the hedged item.
• Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

• For hedges where the derivative instrument is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately. The cost (book value) basis used to figure gain/loss on the derivative instrument will be zero.

• Open foreign currency swap and forward contracts hedging foreign currency exposure on items denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

  • The foreign exchange premium (discount) on the currency contract will be amortized into income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened.

  • Amortization is not required if the contract was entered into within a year of maturity.

  • A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as done to translate the hedged item.

  • The unrealized gain/loss for the period equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the prior period end spot rate.

  • The statement value of the currency contract equals the amortized (premium) discount plus the cumulative unrealized gain/(loss) on the contract. The cumulative unrealized gain/(loss) equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened.

  • Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.

  • For hedges where the cost of the foreign currency contract is combined with the hedged item, the statement value would be zero. The market value of the hedging and hedged items will be determined and reported separately.
If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

Companies which elect to recognize gain/loss currently on derivative instruments acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

For hedges of items which are not subject to IMR, derivative instruments shall be valued at current market value (marked to market) with unrealized gains/losses recognized as adjustments to surplus.

For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Cash Flows and Income:

Where the cost of the derivative instrument is not combined with the hedged item:

- Amortization of premium or discount on derivative instruments is an adjustment to net investment (operating) income through Exhibit 2.

- Periodic cash flows and accruals of income/expense are to be reported in a manner consistent with the hedged item, usually as other investment income (operating income) to be reported in Exhibit 2.

Where the cost of the derivative instrument is combined with the hedged item, the cash flows and income of the derivative instrument on Schedule DB will be zero. All related amortization and cash flow accounting will be reported with the hedged item instead of with the derivative instrument.

(4) Gain/Loss on Termination (includes closing, exercise, maturity, and expiry):

- Exercise — The remaining book value of the derivative instrument shall become an adjustment to the cost or proceeds of the hedged item(s) received or disposed of individually or in aggregate.

- Sale, maturity, expiry, or other closing transaction of a derivative instrument which is an effective hedge — Any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.
• Gain/loss on termination of derivatives will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

• Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on derivative instruments acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.

• For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

(c) Futures

(1) Accounting at Date of Acquisition:

Positions in futures contracts shall be initially valued at the amount of cash deposits (i.e., basis or book value of the contract), if any, placed with a broker. Subsequent additions (reductions) in cash deposits plus changes in contract value from date of contract opening (i.e., variation margin) paid (received) will increase (decrease) the book value of the futures contract.

(2) Statement Value:

• Hedges of Items Carried at Amortized Cost (where the company does not elect to recognize gain/loss currently):
  
  • Futures shall be valued at book value.
  
  • Book value of open futures contracts need not be amortized.
  
  • For hedges where the cost of the futures contract is combined with the hedged item, the statement value would be equal to cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.
  
  • If during the life of the futures contract it is no longer effective as a hedge, valuation at book value (deferral accounting) ceases. A gain/(loss) equal to the variation margin received (paid) shall be recognized as an adjustment to surplus to the extent it ceased to be an effective hedge. Statement value will be limited to the cash deposits outstanding.

• Hedges of Items carried at Market Value (where company does not elect to recognize gain/loss currently):
• Changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently consistent with the hedged item. Statement value will be limited to the cash deposits outstanding.

• Usually this will result in unrealized gain/loss treatment with adjustment to surplus.

• For hedges where the variation margin of the futures contract is combined with the hedged item, the market value of the hedging and hedged items will be determined and reported separately.

• Open foreign currency futures contracts hedging foreign currency exposure on item(s) denominated in a foreign currency and translated into U.S. dollars (where the company does not elect to recognize gain/loss currently):

  • The foreign exchange premium (discount) on the currency contract will be amortized into investment income over the life of the contract. The foreign exchange premium (discount) is defined as the foreign currency (notional) amount to be received (paid) times the net of the forward rate minus the spot rate at the time the contract was opened. The cumulative income recognized since the contract was opened should be reported as recognized variation margin received or (paid).

  • Amortization is not required if the contract was entered into within a year of maturity.

  • A foreign currency translation adjustment should be reflected as an unrealized gain/loss (surplus adjustment) using the same procedures as is done to translate the hedged item. The cumulative unrealized gain/(loss) which equals the foreign currency (notional) amount to be received (paid) times the net of the current spot rate minus the spot rate at the time the contract was opened should be reported as recognized variation margin received or (paid).

  • The statement value of the currency futures contract is book value, including any increase (decrease) for amortization of foreign exchange (premium) discount ((c)(i) above) plus the foreign exchange translation gain/(loss) ((c)(ii) above), which is reported as deferred variation margin.

  • Recognition of unrealized gains/losses and amortization of foreign exchange premium/discount on anticipated firm commitments may be deferred until the hedged transaction occurs. These deferred gains/losses will adjust the basis or proceeds of the hedged transaction when it occurs.
• For hedges where the variation margin of the foreign currency contract is combined with the hedged item, the statement value would equal the cash deposits outstanding. The market value of the hedging and hedged items will be determined and reported separately. Market value on futures contracts is limited to the value of the cash deposits outstanding.

• If during the life of the currency contract it is not effective as a hedge, valuation at amortized cost ceases. To the extent it ceased to be an effective hedge, a cumulative unrealized gain/loss will be recognized as an adjustment to surplus equal to the notional amount times the difference between the forward rate available for the remaining maturity of the contract (i.e., the forward rate as of the balance sheet date) and the forward rate at the time it ceased to be an effective hedge.

• Companies which elect to recognize gain/loss currently on futures contracts acting as hedges shall make that determination at the start of the transaction and shall apply the methodology consistently between periods and by category.

• For hedges of items which are not subject to IMR, changes in contract value from date of contract opening (i.e., variation margin) shall be recognized currently as unrealized gain/loss adjustment to surplus. Statement value will be limited to the cash deposits outstanding.

• For hedges of items which are subject to IMR, derivative instruments shall be valued at amortized cost as in (2)(a) above.

(3) Gain/Loss on Termination:

• Settlement at maturity of a futures contract — The remaining variation margin of the futures contract shall become an adjustment to the cost or proceeds of the hedged item(s) received, disposed of or held, individually or in aggregate.

• Sale or other closing transaction of a futures contract which is an effective hedge — any gain or loss on the transaction will adjust the basis (or proceeds) of the hedged item(s) individually or in aggregate.

• Gain/loss on termination of futures contracts will be recognized currently in net income (realized gain/loss) to the extent they ceased to be effective hedges.

• Where it is impractical to allocate gains or losses from effective hedges to specific hedged assets or liabilities, the company may recognize (realize) the gain/loss on termination in net income. Companies which elect to recognize gain/loss on futures contracts acting as hedges shall make that determination at the start of the derivative transaction and shall apply the methodology consistently between periods and by investment category.
• For insurers subject to IMR the gain/loss will be subject to IMR if the hedged items are subject to IMR.

41. Chapter 8 in the Life/A&H and P&C Accounting Practices and Procedures Manuals contain the following guidance relating to insurance futures and insurance future options:

Insurance Futures and Insurance Futures Options

The statutes, regulations and administrative rulings of the insurers domiciliary state establish the authority to engage in transactions with respect to insurance futures and insurance futures options. In the absence of specific written authority, the Insurance Department of the insurers domiciliary state should be consulted as to such authority.

In those jurisdictions which authorize transactions with respect to insurance futures and insurance futures options, an insurance company is generally permitted, subject to applicable quantitative limitations, to use such instruments to hedge against adverse development in its incurred losses. This strategy typically would involve any or a combination of (i) the purchase of insurance futures contracts, (ii) the purchase of a call option on insurance futures contracts, or (iii) the sale (writing) of a put option on insurance futures contracts.

Insurance Futures Contracts:

An insurance futures contract is a futures contract based on an underlying index of performance of insurance contracts (policies) or factors relating thereto. An insurance futures contract also may be defined more specifically under the statutes, regulations and administrative rulings of a particular state. In connection with a given insurance futures position, an insurer is required by the listing exchange to maintain a margin deposit with respect to the underlying insurance futures contracts purchased.

An insurer should report the amount of any margin deposit as an asset on its balance sheet, which deposit should be reflected as an aggregate write-in for other than invested assets. The specific statutory accounting treatment of increases or decreases in the value of the subject contracts will depend on whether the insurance futures position constitutes a hedge of the insurers incurred losses. The determination of whether an insurance futures position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures position that does not constitute a hedge, the following presents both hedge accounting and other than hedge accounting treatment. Other than hedge accounting should be used in the event that an original hedge position loses its character as such, until such time as the position is terminated as required by state law.

Insurance Futures - Hedge Accounting:

The following treatment would be applicable to insurance futures positions that effectively hedge an insurers incurred losses. With respect to any insurance futures position which corresponds to incurred losses for the current reporting period, any increases (decreases) in the value of the insurance futures contracts should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any insurance futures position which corresponds to a period beyond the current reporting period, any increases (decreases) in the value of the underlying insurance futures contracts should be reported as a direct increase (decrease) in the insurers surplus, as an aggregate write-in for gains and losses in surplus. When such insurance futures position thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurers other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in value of the insurance futures contracts. In either of the foregoing instances, the increase (decrease) in the market value of the insurance futures contracts should either (i) increase (decrease) the aggregate write-in for other than invested assets, to the extent that such
increase (decrease) effects the corresponding margin deposit, or (ii) increase (decrease) cash or other assets, to the extent of mark-to-market payments that are not maintained as a margin deposit. When the insurance futures position is eventually closed, any corresponding margin balance (i.e., aggregate write-in for other than invested assets) shall be transferred to the insurers cash or other assets, as appropriate.

Insurance Futures - Other than Hedge Accounting:

If the insurance futures position is no longer effective as a hedge, any increases (decreases) in the value of the insurance futures contracts should be reported as an aggregate write-in for miscellaneous income. When the insurance futures positions eventually close, any corresponding margin balance (i.e., aggregate write-in for other than invested assets) should be transferred to the insurers cash or other assets, as appropriate.

Options on Insurance Futures Contracts:

An insurance futures option is either a put or call option on an insurance futures contract. An insurance futures call option is a contract under which the holder has the right to purchase the underlying insurance futures contract covered by the option at a stated price (strike price) on or before a fixed expiration date. An insurance futures put option gives the holder the right to sell the underlying insurance futures contract. The consideration paid (received) for the purchase (sale) of an insurance futures option is referred to as a premium. Because all insurance futures options relate to an underlying insurance futures contract, the statutory accounting treatment of insurance futures options generally follows the treatment afforded insurance futures contracts.

An insurer should report the amount of any premium paid for an insurance futures option as an asset on its balance sheet, which premium should be reflected as an aggregate write-in for other than invested assets. Similarly, an insurer should report the amount of any premium received for the sale (writing) of an insurance futures option as a liability on its balance sheet, which premium should be reflected as an aggregate write-in for liabilities. The specific statutory accounting treatment of increases or decreases in the market value of the subject insurance futures option will depend on whether such position constitutes a hedge of the insurers incurred losses. As with insurance futures contracts, the determination of whether a particular position constitutes a hedge is typically determined pursuant to the statutes, rules and administrative rulings of an insurers domiciliary state. Although many states prohibit an insurer from taking an insurance futures option position that does not constitute a hedge, the following presents both hedge accounting and other than hedge accounting treatment. Other than hedge accounting should be used in the event that an original hedge position loses its characters as such, until such time as the position is terminated as required by state law.

Options on Insurance Futures Contracts - Hedge Accounting:

The following treatment would be applicable to insurance futures options positions that effectively hedge an insurers incurred losses.

(a) Purchase of Call Options — With respect to any call option which corresponds to incurred losses for the current reporting period, any increases (decreases) in the market value of the option should be reported as an increase (decrease) in the insurers other income, as an aggregate write-in for miscellaneous income for the subject period. With respect to any call option which corresponds to a period beyond the current reporting period, any increases (decreases) in the market value of the underlying option should be reported as a direct increase (decrease) in the insurer's surplus, as an aggregate write-in for gains and losses in surplus. When such option thereafter corresponds to a current reporting period, the initial increase (decrease) in direct surplus should be reversed and such amount should be appropriately reported as an increase (decrease) to the insurer's other income, as an aggregate write-in for miscellaneous income for the current period, along with any current changes in the market value of the option.
If the option position is terminated through a closing transaction, the corresponding balance of the asset (i.e., aggregate write-in for other than invested assets) should be eliminated, with a corresponding charge to cash or other assets, as appropriate. If the option is exercised, the corresponding balance of the asset should be eliminated, with a corresponding charge to either (i) insurance futures margin (i.e., aggregate write-in for other than invested assets), to the extent of margin deposit requirements, or (ii) cash or other assets, as appropriate. If the option expires, the corresponding balance of the asset should be eliminated, with an appropriate decrease to the insurer’s other income, as an aggregate write-in for miscellaneous income.

(b) Sale (Writing) of Put Options — The statutory accounting treatment for the sale (writing) of insurance futures put options is essentially the mirror image of the foregoing treatment presented with respect to purchased call options. Upon termination (through a closing transaction), exercise or expiry of the put option, the corresponding balance of the liability (i.e., aggregate write-in for liabilities) should be eliminated, in the mirror image of the foregoing treatment.

Options on Insurance Futures Contracts - Other than Hedge Accounting:

If the insurance futures option position is no longer effective as a hedge, any increases (decreases) in the value option should be reported as an aggregate write-in for miscellaneous income.

42. The NAIC Annual Statement Instructions for both Life, Accident and Health and Property and Casualty companies require the following disclosures for derivative instruments:

Instruction:

Disclose the following information by category of derivative financial instrument:

a. A description of the Company’s objectives for holding or issuing derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives including the classes of derivative financial instrument used.

b. The nature and terms of derivative financial instruments, including, at a minimum, a discussion of: 1) the credit and market risk of those instruments, and 2) the cash requirements of those instruments (including the effects of possible termination payments).

Illustration for Interest Rate Swaps (Companies should modify the following to reflect appropriately their own circumstances):

The Company uses interest rate swaps to reduce market risks from changes in interest rates and to alter interest rate exposures arising from mismatches between assets and liabilities. Under interest rate swaps, the Company agrees with other parties to exchange, at specified intervals, the difference between fixed-rate and floating-rate interest amounts calculated by reference to an agreed notional principal amount. Generally, no cash is exchanged at the outset of the contract and no principal payments are made by either party. A single net payment is usually made by one counterparty at each due date. See Schedule DB.

The Company is exposed to credit-related losses in the event of nonperformance by counterparties to financial instruments, but it does not expect any counterparties to fail to meet their obligations given their high credit ratings. The credit exposure of interest rate swaps is represented by the fair value (market value) of contracts with a positive fair value (market value) at the reporting date.
Illustration for All Other Derivatives Listed in Schedule DB (Caps, Collars, Futures, etc.):

The note(s) may resemble the illustration for interest rate swaps. For additional illustrations, see C.M. Antis’ Financial Accounting Series Special Report, Illustrations of Financial Instrument Disclosures (No. 144-c), December 1994, published by the Financial Accounting Standards Board.

43. The following guidance for derivatives used for income generation was adopted by the Financial Condition (EX4) Subcommittee on December 14, 1996:

INCOME GENERATION ACCOUNTING PROJECT
EXECUTIVE SUMMARY
JULY 10, 1996

INTRODUCTION

Income Generation transactions are ones where the company writes (or sells) derivative instruments to generate additional income or return to the company. They include covered options, caps and floors such as when a company writes an equity call option on stock which it already owns. Currently they represent a small portion of the insurance industry’s derivative activity in terms of number of companies involved, number of transactions, and dollar amounts involved. The possibility of greater company involvement in the future exists given recent guidance and inclusion in the Model Investment Law.

Because these transactions involve writing derivative transactions, they expose the company to potential future liabilities for which the company receives a premium up front. Because of this risk, state laws and the Model Investment Law impose dollar limitations and additional constraints requiring that they be “covered,” i.e., that there be offsetting assets which can be used to fulfill potential obligations. To this extent the combination of instruments works like a reverse hedge where an asset owned by the company in essence hedges the derivative risk.

As with derivatives in general these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

GENERAL ATTRIBUTES

The proposed accounting and reporting approach is intended to meet (1) Regulatory needs focusing on company and Industry solvency (2) company needs focusing on administrative and cost considerations, and (3) the general need to provide meaningful and relevant information regarding the substance of the transactions and holdings for all users of the financial statements.

1. The approach is conservative and reduces the potential for income manipulation. Income is not recognized early in the holding period only to be reversed by future losses. This consideration is particularly important for options which could have lower exercise prices than the combined statement values of the derivative and the covering asset.

2. The approach is reasonably simple and consistent with Statutory accounting. It builds on accounting guidance which already exists in the NAIC Accounting Practices and Procedures Manual and in the Annual Statement Instructions regarding hedging.

3. The approach looks to the substance of the transactions involved.
   - It matches the accounting of the derivative with the accounting of the covering asset or underlying interest.
It includes an alternative treatment which combines the derivative with the covering asset. This results in a treatment analogous to callable bonds where the option feature is combined with the asset rather than in two pieces.

It allows for recognition of the time value/interest rate factor implicit in the pricing of these instruments, particularly relevant for derivatives with longer maturities.

ACCOUNTING SPECIFICS

The accounting specifics attached are presented in table form. Completed sections include

- Covered Call Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Covered Put Writing
  - Underlying Interest at Amortized Cost
  - Underlying Interest at Market
- Covered Cap and Floor Writing
  - Covering Item at Amortized Cost
  - Covering Item at Market
- Accounting Examples
- AVR Implications
- Approval by AVR/IMR Study Group
- Formal Blanks Proposal

General

The principal features to date are:

1. The premium received is initially recorded as a deferred liability.

2. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either mark-to-market (e.g., common stocks) or (amortized) cost (e.g., for bonds).

3. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it would be subject to IMR treatment if interest rate related.

4. For options which are exercised, the remaining premium would adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.

Covered puts and fixed income transactions have several specific features which are presented below.

Fixed Income Call Options

The principal specific features are:

1. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract.

2. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income
feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds.

3. For life insurance companies the gain or loss flows through the IMR if the underlying interest or covering asset is subject to the IMR using callable bond rules to determine the remaining life.

4. Companies writing options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset should be evaluated for write down or disclosure treatment along the lines of Codification Issue Paper #5 Definition of Liabilities, Loss Contingencies, and Impairments of Assets taking into consideration all relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect surplus and income.

Puts

The principal features are:

1. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a company wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the company might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case.

2. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest.

3. As with covered call writing, companies writing put options for income generation purposes are responsible for timely recognition of any probably losses that may occur as a result of the strategy.

Fixed Income Caps and Floors

The principal specific features are:

1. The value of the premium received would be amortized into income over the life of the contract. For caps and floors, where the company is selling off possible excess interest/income, the value of the covering asset is not relevant.

2. Again, gain/loss may be subject to IMR. The expected maturity would be the derivative contract’s maturity.
WRITTEN CALL OPTIONS – INCOME GENERATION
PROPOSED STATUTORY ACCOUNTING TREATMENT
APPLICABLE TO ALL INSURANCE COMPANIES
JULY 30, 1996

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET AT AMORTIZED COST</th>
<th>COVERING ASSET AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting. (2)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable. (3)</td>
<td></td>
</tr>
</tbody>
</table>

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.


3. If premium is attached to covering asset, the accounting treatment for the covering asset applies.
<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at consideration received. (1)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized capital gain.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium received.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognized net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

NOTES

1. A general statement will be added to the instructions stating that companies writing options for income generation purposes are responsible for the timely recognition of any probable losses that may occur as a result of the strategy due to holding and accounting for options on Schedule DB – Part B.
### Status of Option

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET AT AMORTIZED COST</th>
<th>COVERING ASSET AT MARKET VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if within 1 yr of maturity.)</td>
<td>Mark to market with changes in market value recorded as unrealized adjustments to surplus – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR if applicable.</td>
<td></td>
</tr>
<tr>
<td>Disclosure</td>
<td>(OPEN ITEM—being addressed by other Interested Persons.) Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implication.</td>
<td>(OPEN ITEM—being addressed by other Interested Persons.) Details of covered items and/or written transactions to allow actuaries to evaluate cash flow implications.</td>
</tr>
</tbody>
</table>

### Generally Accepted Accounting Principles

44. The key GAAP literature relating to hedge accounting for derivative financial instruments is found in FAS 80. Paragraphs 3 and 4 of FAS 80 state, in part:

3. A change in the market value of a futures contract shall be recognized as a gain or loss in the period of the change unless the contract meets the criteria specified in this Statement to qualify as a hedge of an exposure to price or interest rate risk. If the hedge criteria are met, the accounting for the futures contract shall be related to the accounting...
for the hedged item so that changes in the market value of the futures contract are recognized in income when the effects of related changes in the price or interest rate of the hedged item are recognized.

4. In applying this Statement, both of the following conditions shall be met for a futures contract to qualify as a hedge:

a. The item to be hedged exposes the enterprise to price (or interest rate) risk. In this Statement, risk refers to the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions. To meet this condition, the item or group of items intended to be hedged must contribute to the price or interest rate risk of the enterprise. In determining if this condition is met, the enterprise shall consider whether other assets, liabilities, firm commitments, and anticipated transactions already offset or reduce the exposure. An enterprise that cannot assess risk by considering other relevant positions and transactions for the enterprise as a whole because it conducts its risk management activities on a decentralized basis can meet this condition if the item intended to be hedged exposes the particular business unit that enters into the contract.

b. The futures contract reduces that exposure and is designated as a hedge. At the inception of the hedge and throughout the hedge period, high correlation of changes in (1) the market value of the futures contract(s) and (2) the fair value of, or interest income or expense associated with, the hedged item(s) shall be probable so that the results of the futures contract(s) will substantially offset the effects of price or interest rate changes on the exposed item(s). In addition to assessing information about the correlation during relevant past periods, the enterprise also shall consider the characteristics of the specific hedge, such as the degree of correlation that can be expected at various levels of higher or lower market prices or interest rates. A futures contract for a commodity or a financial instrument different from the item intended to be hedged may qualify as a hedge provided there is a clear economic relationship between the prices of the two commodities or financial instruments, and provided high correlation is probable.

45. Paragraph 21 of FAS 52 states, in part:

A gain or loss on a forward contract or other foreign currency transaction that is intended to hedge an identifiable foreign currency commitment (for example, an agreement to purchase or sell equipment) shall be deferred and included in the measurement of the related foreign currency transaction...A foreign currency transaction shall be considered a hedge of an identifiable foreign currency commitment provided both of the following conditions are met:

a. The foreign currency transaction is designated as, and is effective, as a hedge of a foreign currency commitment.

b. The foreign currency commitment is firm.

46. The key GAAP literature relating to interest rate swap transactions is EITF 84-36, in which the Task Force concluded that:

...if there is an underlying debt obligation on the balance sheet of the company entering into the swap transaction, the company should account for the swap agreement like a hedge of the obligation and record interest expense using the revised interest rate, with any fees or other payments amortized as yield adjustments.

47. FAS 105, as amended by FAS 119, provides the following guidance on disclosures for financial instruments with off-balance sheet risk, including derivatives:
6. A financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

   a. Imposes on one entity a contractual obligation\(^1\) (1) to deliver cash or another financial instrument\(^2\) to a second entity or (2) to exchange financial instruments on potentially unfavorable terms with the second entity

   b. Conveys to that second entity a contractual right\(^3\) (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.

\(^1\) Contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual obligations that are financial instruments meet the definition of liability set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements*, although some may not be recognized as liabilities in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the obligations is owed to or by a group of entities rather than a single entity.

\(^2\) The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

\(^3\) Contractual rights encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights that are financial instruments meet the definition of asset set forth in Concepts Statement 6, although some may not be recognized as assets in financial statements—may be “off-balance-sheet”—because they fail to meet some other criterion for recognition. For some financial instruments, the right is held by or the obligation is due from a group of entities rather than a single entity.

7. The risk of accounting loss\(^4\) from a financial instrument includes (a) the possibility that a loss may occur from the failure of another party to perform according to the terms of a contract (credit risk), (b) the possibility that future changes in market prices may make a financial instrument less valuable or more onerous (market risk),\(^5\) and (c) the risk of theft or physical loss. This Statement addresses credit and market risk only.

\(^4\) Accounting loss refers to the loss that may have to be recognized due to credit and market risk as a direct result of the rights and obligations of a financial instrument.

\(^5\) A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).


17. For financial instruments with off-balance-sheet risk\(^*\), except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:\(^12\)

   a. The face or contract amount (or notional principal amount if there is no face or contract amount)

   b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.\(^13\)
** Similar disclosures are required for derivative financial instruments without off-balance-sheet risk in paragraph 8 of FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.

12 In this Statement, category of financial instrument refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying—classifying—similar financial instruments in statement of financial position, in notes to financial statements, and in various regulatory reports have developed and become generally accepted, largely without being codified in authoritative literature. In this Statement, class of financial instrument refers to those classifications.

13 Paragraph 12 of Opinion 22 as amended by FASB Statement No. 95, Statement of Cash Flows, says:

Disclosure of accounting policies should identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, statement of cash flows, or result of operations. In general, the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue and allocation of asset costs to current and future periods; in particular, it should encompass those accounting principles and methods that involve any of the following:

a. A selection from existing acceptable alternatives.

b. Principles and methods peculiar to the industry in which the reporting operates, even if such principles and methods are predominantly followed in that industry.

c. Unusual or innovative applications of generally accepted accounting principles (and, as applicable, of principles and methods peculiar to the industry in which the reporting entity operates).

The disclosures required in paragraph 17 shall distinguish between financial instruments with off-balance-sheet risk held or issue for trading purposes, included dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

**Disclosure of Credit Risk of Financial Instruments with Off-Balance-Sheet Credit Risk**

18. For financial instruments with off-balance-sheet credit risk, except as noted in paragraphs 14 and 15, an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument:

a. The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity.

b. The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

19. An entity may find that disclosing additional information about the extent of collateral or other security for the underlying instrument indicates better the extent of credit risk. Disclosure of that additional information in those circumstances is encouraged.

48. FAS 119 provides the following guidance on disclosures for derivatives:

8. For options held and other derivative financial instruments not included in the scope of Statement 105 (because they do not have off-balance-sheet risk of accounting loss, as defined in Statement 105), an entity shall disclose either in the body of the financial statements or in the accompanying notes the following information by category of financial instrument.
a. The face or contract amount (or notional principal amount if there is no face or contract amount)\(^2\)
b. The nature and terms, including, at a minimum, a discussion of (1) the credit and market risk of those instruments, (2) the cash requirements of those instruments, and (3) the related accounting policy pursuant to the requirements of APB Opinion No. 22, Disclosure of Accounting Policies.

\(^1\) In this Statement, \textit{category of financial instrument} refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also shall describe for each category the classes of financial instruments included in that category.

\(^2\) Disclosure of the face or contract amount of financial instruments, including those within the scope of Statement 105, may be misleading when the instruments are leveraged and the leverage features are not adequately disclosed. For example, the optional amounts of the interest rate swap may be misleading if the contract’s settlement payments are based on a formula that multiplies the effect of interest rate changes. Disclosure of the nature and terms of those instruments requires a discussion of the leverage features and their general effects on (a) the credit and market risk, (b) the cash requirements, and (c) the related accounting policy.

9. The disclosures required in paragraph 8 of this Statement shall distinguish between derivative financial instruments held or issued for:
   a. Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings
   b. Purposes other than trading.

10. Entities that hold or issue derivative financial instruments for trading purposes shall disclose, either in the body of the financial statements or in the accompanying notes, the following:
   a. The average fair value of those derivative financial instruments during the reporting period\(^3\), presented together with the related end-of-period fair value, distinguishing between assets and liabilities
   b. The net gains or losses (often referred to as net trading revenues) arising from trading activities during the reporting period disaggregated by class, business activity, risk, or other category that is consistent with the management of those activities and where those net trading gains or losses are reported in the income statement. If the disaggregation is other than by class, the entity also shall describe for each category the classes of derivative financial instruments, other financial instruments, and nonfinancial assets and liabilities from which the net trading gains or losses arose.

\(^3\) The calculation based on average fair value based on daily balances is preferable to a calculation based on less frequent intervals. It is, however, sufficient to disclose average fair value based on the most frequent interval that a trader’s systems generate for management, regulatory, or other reasons.

11. Entities that hold or issue derivative financial instruments for purposes other than trading shall disclose the following:
a. A description of the entity's objectives for holding or issuing the derivative financial instruments, the context needed to understand those objectives, and its strategies for achieving those objectives, including the classes of derivative financial instruments used for the purpose.

b. A description of how each class of derivative financial instrument is reported in the financial statements including the policies for recognizing (or reasons for not recognizing) and measuring the derivative financial instruments held or issued, and when recognized, where those instruments and related gains and losses are reported in the statements of financial position and income.

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For example, if an entity’s objective for a derivative position is to keep a risk arising from the entity’s nonderivative assets below a specified level, the context would be a description of those assets and their risk, and a strategy might be purchasing put options in a specified proportion to the assets at risk.

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c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions (both firm commitments and forecasted transactions for which there is no firm commitment), (1) a description of the anticipated transactions whose risks are hedged, including the period of time until the anticipated transactions are expected to occur, (2) a description of the classes of derivative financial instruments used to hedge the anticipated transactions, (3) the amount of hedging gains and losses explicitly deferred, and (4) a description of the transactions or other events that result in the recognition in earnings of gains or losses deferred by hedge accounting.

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For purposes of the disclosure of hedging gains and losses, the term explicitly deferred refers to deferrals in separate accounts in the manner required by FASB Statement No. 80, Accounting for Futures Contract, for hedges of anticipated transactions and by FASB Statement No. 52, Foreign Currency Translation, for hedges of firm commitments. Those deferrals are in contrast to implicit deferrals that are (a) embedded in related carrying amounts for hedges of recognized assets and liabilities or (b) not recorded because changes in the value of the hedging instrument are not recognized.

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12. Entities are encouraged, but not required, to disclose quantitative information about interest rate, foreign exchange, commodity price, or other market risks of derivative financial instruments that is consistent with the way the entity manages or adjusts those risks and that is useful for comparing the results of applying the entity's strategies to its objectives for holding or issuing the derivative financial instruments. Quantitative disclosures about the risks of derivative financial instruments are likely to be even more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about the risks of other financial instruments or nonfinancial assets and liabilities to which the derivative financial instruments are related by a risk management or other strategy.

13. Appropriate ways of reporting the quantitative information encouraged in paragraph 12 will differ for different entities and will likely evolve over time as management approaches and measurement techniques evolve. Possibilities include disclosing (a) more details about current positions and perhaps activity during the period, (b) the hypothetical effects on equity, or on annual income, of several possible changes in market prices, (c) a gap analysis of interest rate repricing or maturity dates, (d) the duration of the financial instruments, or (e) the entity's value at risk from derivative financial instruments and from other positions at the end of the reporting period and the average value at risk during the year. This list is not exhaustive, and entities are encouraged to develop other ways of reporting the quantitative information.
OTHER SOURCES OF INFORMATION

49. Excerpts from the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force Meeting on June 2, 1996

Derivatives Projects

Ann Bottelli (Prudential Insurance) gave a report on four derivatives projects that had been ongoing in the Invested Asset Working Group. The first report dealt with a blanks proposal to add a column to Schedule DB Part E Section 1 dealing with off-balance sheet exposure for derivatives securities. This amount is needed for risk based capital calculations. Following Ms. Bottelli’s comments, a motion was made and seconded to adopt the blanks proposal and send it on to the Blanks Task Force. That motion passed. (Attachment A)

Ms. Bottelli next gave a report on the required disclosure for anticipatory hedging. The disclosure would bring NAIC disclosure in line with generally accepted accounting principles (GAAP) disclosure requirements for derivatives securities. Following Ms. Bottelli’s comments on the reporting mechanisms, Larry Gorski (Ill.) pointed out that this report and blanks proposal was in no way an endorsement for the use of anticipatory hedging, which he pointed out is prohibited in certain states. Following Mr. Gorski’s comments, a motion was made and seconded to adopt the blanks proposal and forward it to the Blanks Task Force. That motion passed. (Attachment B)

Next, Ms. Bottelli gave a report dealing with guidance for the interest maintenance reserve (IMR) for hedging. This guidance will appear in the Financial Examiners Handbook and will deal with IMR gains and losses from derivative hedges. A motion was made and seconded to send this proposal to the Accounting Handbook and Instructions Working Group. That motion passed. (Attachment C)

Finally, Ms. Bottelli gave a report dealing with the accounting for income generating derivative transactions. This report contained two blanks proposal items, as well as definitional material that should be added to the Accounting Practices and Procedures Handbook. Following Ms. Bottelli’s comments, Mr. Gorski again pointed out that this report was in no way an endorsement of using derivatives for anything other than hedging purposes. Following some concerns by the working group members that they did not have sufficient time to review this proposal, a motion was made and seconded to receive the report by the working group. (Attachment D) That motion was passed by the working group. Ron Newton (Texas) asked if the two blanks proposals would be sent to the Blanks Task Force. Mr. Gorski responded that they would be held until a final review could be done by the Invested Asset Working Group members.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and for Property and Casualty Insurance Companies, Chapter 8, Other Admitted Assets
- Annual Statement Instructions for Property and Casualty Insurance Companies
- Annual Statement Instructions for Life, Accident and Health Insurance Companies
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 81 - Foreign Currency Transactions and Translations
- Minutes of the December 14, 1996 meeting of the Financial Condition (EX4) Subcommittee (Minutes included the Executive Summary of the Income Generation Accounting Project dated July 10, 1996)
Generally Accepted Accounting Principles
- FASB Statement No. 52, Foreign Currency Translation
- FASB Statement No. 80, Accounting for Futures Contracts
- 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, Disclosure about Fair Value of Financial Instruments
- FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments
- FASB Emerging Issues Task Force Issue No. 84-7, Termination of Interest Rate Swaps
- FASB Emerging Issues Task Force Issue No. 84-14, Deferred Interest Rate Setting
- FASB Emerging Issues Task Force Issue No. 84-36, Interest Rate Swap Transactions
- FASB Emerging Issues Task Force Issue No. 86-34, Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions
- FASB Emerging Issues Task Force Issue No. 87-2, Net Present Value Method of Valuing Speculative Exchange Contracts
- FASB Emerging Issues Task Force Issue No. 88-8, Mortgage Swaps
- FASB Emerging Issues Task Force Issue No. 90-17, Hedging Foreign Currency Risk with Purchased Options
- FASB Emerging Issues Task Force Issue No. 91-1, Hedging Intercompany Foreign Currency Risks
- FASB Emerging Issues Task Force Issue No. 91-4, Hedging Foreign Currency Risks with Complex Options and Similar Transactions
- FASB Emerging Issues Task Force Issue No. 96-11, Accounting for Forward Contracts and Purchase Options to Acquire Securities Covered Under FASB Statement No. 115

Other Sources of Information
- Minutes of the June 2, 1996 meeting of the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force
Statutory Issue Paper No. 86
Securitization

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans which serve as collateral for mortgage-backed securities.


3. In June 1996 the Financial Accounting Standards Board issued FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125). This standard supersedes FASB Statement No. 77, Reporting by Transferors for Transfers of Receivables with Recourse, (FAS 77) and FASB Technical Bulletin 85-2, Accounting for Collateralized Mortgage Obligations (CMOs) (FTB 85-2). The types of transactions contemplated in the statement recognize recent innovations in the financial markets. It addresses transfers accomplished through securitizations as well as other types of transfers.

4. The purpose of this issue paper is to establish statutory accounting principles for asset securitizations and securitizations of policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper is not intended to address transfers accomplished by means other than securitization.

SUMMARY CONCLUSION

Accounting for Securitizations of Financial Assets

5. As used in this issue paper a financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that conveys both

   a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with a second entity; and

   b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

6. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no
measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 13.

7. The transferor has surrendered control if, and only if, all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.
   b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests.
   c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

8. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

9. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 7, the transferor shall:
   a. Eliminate the transferred assets from the statement of financial position.
   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer.
   c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities).
   d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9.c.) and liabilities incurred in consideration as proceeds of the sale.
   e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value.
   f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the Investment Income section of the Underwriting and Investment Exhibit.

10. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.
11. A qualifying special-purpose entity (including CMO special-purpose entities) as used in this issue paper must meet all of the following conditions:

   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

      1. Holding title to transferred financial assets
      2. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
      3. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
      4. Distributing proceeds to the holders of its beneficial interests.

   b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

Investments in Special-Purpose Entities
12. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

Secured Obligations and Collateral
13. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 7 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity’s books and a liability shall be recorded to reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights
14. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the income statement. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35 through 38 of FAS 125.
Sales of Future Revenues
15. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

DISCUSSION
16. The conclusions reached in this issue paper are consistent with the statutory guidance set forth in the minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force (Emerging Accounting Issues Working Group) which address securitization of mortgage loans and mortgage-backed securities except that the gain on sale shall be recognized immediately rather than deferred and amortized over the life of the retained interests. This issue paper is also consistent with the minutes of the February 21, 1992 meeting of the Emerging Accounting Issues Working Group which addressed financings secured by mortgage loans which have related repurchase agreements.

17. This issue paper adopts FAS 125, with the following modifications:
   a. This issue paper requires servicing rights assets to be nonadmitted.
   b. This issue paper does not permit sales treatment for transactions where recourse provisions exist where “call” or “put” options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances.
   c. This issue paper requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets.
   d. This issue paper does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers.
   e. Paragraph 14 is rejected as it is not applicable.

18. With respect to securitizations meeting the criteria of paragraph 7, statutory and GAAP do not recognize as a sale, any portion of the transfer for which securities representing beneficial interests in the transferred assets (e.g., CMOs) are obtained by the transferor. Statutory and GAAP do recognize that the securitized assets (e.g., mortgages) are no longer assets of the reporting entity and that the reporting entity has essentially replaced the transferred assets with securities representing a beneficial interest in the transferred assets.

19. This paper is consistent with GAAP in that the securities representing the retained beneficial interests are recorded by the reporting entity in the statement of financial position at the their allocated carrying value, since the securities represent a continuing control over a previous asset, albeit in a different form. Thus, no gain or loss is recognized on the retained beneficial interest.

20. The guidance set forth in this issue paper with respect to reporting pledged collateral and the related liability for the proceeds received from transactions not recognized as sales on a gross basis and not offsetting those amounts is consistent with the guidance set forth in Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities.

21. This issue paper is consistent with the current statutory guidance provided in the Life/A&H Accounting Practices and Procedures Manual. Recording the proceeds received currently for future
revenue as a liability is consistent with the concepts of conservatism and recognition in the Statement of Concepts.

22. While servicing rights meet the definition of an asset, they do not meet the definition of an admitted asset. The conclusion to nonadmit the asset is consistent with the concept of conservatism in the Statement of Concepts.

Drafting Notes/Comments
- Extinguishment of debt is addressed in Issue Paper No. 80 - Debt.
- Levelized commissions are addressed in Issue Paper No. 71 - Policy Acquisition Costs and Commissions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
23. The Life/A&H Accounting Practices and Procedures Manual, Chapter 17, Other Liabilities, provides the following guidance with respect to the sale of future revenue.

Sale of Future Revenues

The immediate recognition of proceeds from certain transactions characterized as "sale" of future revenues in income and/or surplus has been determined to be inappropriate for purposes of statutory reporting. These transactions are sometimes referred to as "securitization" and are sometimes characterized as selling "deferred acquisition costs". Accordingly, a liability should be established for the amount of proceeds, which shall be reduced as the proceeds are repaid.

24. The Minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group provide the following guidance.

Accounting for Real Estate Mortgage Investment Conduits (REMIC's)

The subject of accounting for REMIC's (Real Estate Mortgage Investment Conduits) has been discussed or deferred at a number of meetings of the working group. It was discussed briefly at the October 13, 1988 meeting (EI 88–4) and in greater detail at subsequent meetings. An issue summary prepared by Norris Clark (Attachment A) was used as the initial basis for discussion.

Under the Tax Reform Act of 1986, mortgages may be placed in trust and certificates, junior and senior, may be issued. Certificate holders are entitled to receive a proportionate share of the payments made on the underlying pool of mortgages. This mortgage pass–through may be treated as a Real Estate Mortgage Investment conduit (REMIC) under the act. Generally an insurer will transfer a pool of mortgages to the trust and receive the Senior Certificates (seniors) and Junior Certificates (juniors). The seniors are then offered to the public at a somewhat lower interest rate than the pool will produce. The insurer will retain the juniors, at least initially. Rights to receive payment on the juniors will be subordinate to the rights of the seniors. A third type of instrument, a residual instrument, may also be part of the REMIC. This part may be very small.

At its June 5, 1989 meeting (89–2), the working group reached conclusions on the following two issues relating to REMIC's:

1. If an insurer holds a junior, how should it report its holdings, as a bond or equity or some other form of security?

   It was the consensus of the working group that the holding of a junior should be reported as a bond.

2. If a junior is a bond, how should it be valued?

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The consensus of the working group was that it should be valued in accordance with procedures established by the NAIC Securities Valuation Office. (However, this conclusion was modified by the group during its March 26, 1990 meeting. See Number 3. below.)

A third issue was also discussed at the June 5, 1989 meeting (EI 89–2) and at subsequent meetings of the working group. At the December 4, 1989 meeting (EI 89–4) the working group reviewed a paper (Attachment B) in the form of an issue summary prepared by Ransom Jones of Goldman, Sachs. Mr. Jones and Katherine Mason agreed to illustrate a transaction for the March 1990 meeting (Attachment C). Mr. Clark also provided an illustration (Attachment D) of the transaction which had been the impetus for his original issue summary.

Following a discussion of the material provided, the working group reached the following conclusions on accounting for these transactions:

1. How should the allocated basis of each of the layers or tranches be determined?

   The consensus of the working group was that fair market value should be used in determining the allocated basis for each tranche.

2. Should the exchange of mortgages and the issuing of securities be considered a sale and should a gain or loss be recognized?

   The group agreed that the transaction should be considered a sale. It further agreed that any gain or loss arising from the sale of the senior tranche should be recognized. The working group concluded loss, if any, should be recognized immediately. A gain on the sale should be deferred and amortized over the life of the juniors and residuals but in no event faster than the risk retained by the insurer is eliminated.

3. At what value should the juniors and/or residuals be carried by the insurer?

   It was the consensus of the working group that juniors and residuals should initially be carried at their allocated book value. They should be amortized as cash is received and should be periodically assessed as to realizability and valued downward.

The minutes of the February 21, 1992, meeting of the Emerging Accounting Issues Working Group provide the following guidance.

Accounting for Financing Secured by Mortgage Loans

This issue was previously discussed under the caption “Secured Borrowing” during the September 16, 1991 and December 9, 1991 meetings (EI 91-3 and EI 91-4). An issue summary was prepared for this meeting but was revised, particularly with respect to the accounting issues, during the meeting (See Attachment D).

This is an arrangement that creates participation interests in a block of existing mortgage loans for the purposes of utilizing such interests as collateralization for obtaining temporary financing.

Specifically, an insurer (the “transferor”) transfers a designated portion of its portfolio of mortgage loans to a grantor trust. In exchange, the transferor receives mortgage pass-through certificates evidencing one hundred percent beneficial ownership of the trust and the underlying mortgage loans. This phase of the transaction is effected by a pooling and servicing agreement between the transferor and the transferee.

The transaction utilizes a senior/subordinated structure for the transferee. One or more classes of certificates has a senior or first priority lien on the mortgage loan cash flows. One or more classes of subordinated certificates has a subordinated lien on the assets of the trust. The
creation of the subordinated certificates may allow the senior certificates to obtain an investment grade rating from various rating agencies.

In the second phase of the transaction, the transferor enters into a reverse repurchase facility with a financier providing cash for liquidity. This facility is initially in place for one year (with an option by the transferor for an additional year) and will allow the transferor to enter into discrete repurchase transactions for the sale to the financier and subsequent repurchase by the transferor of the higher rated certificates held by the transferor pursuant to the first phase.

An individual repurchase transaction, as drawn on the line of credit provided by the financier, may be for a term as short as overnight or as long as two years. Each transaction is required to be over-collateralized by an amount which will vary relative to the length of the term of the particular sale/repurchase. The certificates that are transferred and serve as collateral remain registered in the name of the transferor, and principal and interest payments thereon shall, absent foreclosure, be for the account of the transferor. At such times as the transferor has satisfied its obligation to the financier under the repurchase facility, the transferor holds the certificates free and clear of any liens.

In the event that the transferor fails to make a required payment of the repurchase price or if the transferor is the subject of insolvency proceedings, then an event of default occurs which enables the financier to foreclose on the collateral and pay itself back the amount of such borrowings. Any collateral remaining would be returned to the transferor.

Preliminary, the working group identified the following issues and reached the following conclusions:

1. Is the transfer of mortgages to the trust a non-economic event?

   Yes. The transaction would be non-economic because an economic event requires a permanent transfer of the risks and rewards of ownership as defined by FAS 77.

2. How should the ownership of the mortgages be accounted for on the balance sheet of the transferor?

   The mortgages should continue to be reported on the balance sheet at the transferor's carrying value, continue to be amortized, and continue to be reported on Schedule B with disclosure in the Notes to the Financial Statements. Each mortgage which has been transferred to the trust should be denoted with a 'c' to indicate its use as collateral as described on page 2-1 of the NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies and the Instructions for Fire and Casualty Insurance Companies.

   Disclosure in the Notes to the Financial Statements should include the number and dollar amounts of mortgages transferred to the trust by type, dollar amounts of the senior and junior certificates, and the life of the trust. Appropriate disclosure should also be made, as applicable, in the General Interrogatories of the Annual Statement. Since the mortgages continue on the books of the insurer/transferor under their previous classifications, no assets or liabilities are shown by the company for the trust.

3. How should an insurance company account for borrowings under this type of arrangement?

   The borrowing transaction would result in an increase in cash or cash equivalents, and a like increase in the liability, borrowed money.

   A disclosure should be made in the Notes to the Financial Statement as required for “Borrowed Money”.
Because of the interest of and certain concerns raised by industry observers at the meeting, the chairman agreed to expose the foregoing preliminary conclusions through these minutes. Final adoption of conclusions by the working group will be made at the June 1992 meeting.

In addition, proposed Accounting Manual language was developed by the working group. The proposed language (for exposure) is attached as Attachment E.

**Generally Accepted Accounting Principles**

26. FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).

b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.

c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)

b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).

11. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:

a. Derecognize all assets sold

b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)

c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)

d. Recognize in earnings any gain or loss on the sale.
The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

3 Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities

13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 35-38).

Financial Assets Subject to Prepayment

14. Interest-only strips, loans, other receivables, or retained interests in securitizations that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended by this Statement (paragraph 233).

4 As a result of that amendment to Statement 115, securities that were previously classified as held-to-maturity may need to be reclassified. Reclassifications of interest-only strips or other securities from held-to-maturity to available-for-sale required to initially apply this Statement would not call into question an entity’s intent to hold other debt securities to maturity in the future.

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:
a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, then
   (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
   (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor’s right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this Statement.

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.

d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:
   a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
   b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

5 If nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt, the sale and related assumption effectively accomplish a legal release of the seller-debtor for purposes of applying this Statement.

Disclosures

17. An entity shall disclose the following:
   a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
   c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
   d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
   e. For all servicing assets and servicing liabilities:
      (1) The amounts of servicing assets or liabilities recognized and amortized during the period
(2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

(3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37.

(4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57(c)).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity must meet both of the following conditions:
   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
      (1) Holding title to transferred financial assets
      (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
(3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held

(4) Distributing proceeds to the holders of its beneficial interests.

b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassert control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it." In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

7 The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.


Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:
   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
   d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

9 In this Statement, the term substantially the same is used consistently with the usage of that term in the AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position.

   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
   b. Identical form and type so as to provide the same risks and rights
   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
   d. Identical contractual interest rates
   e. Similar assets as collateral
   f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have
obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Retained Interests

33. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 31.

Servicing Assets and Liabilities

35. Servicing of mortgage loans, credit card receivables, or other financial assets includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

36. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, unless the transferor securitizes the assets, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced. Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to the servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to
adequately compensate the servicer for performing the servicing, the contract results in a servicing liability.

37. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:
   a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
   b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 33, 34, and 42-46).
   c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
   d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 42-46).
   e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.
   f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
   g. Subsequently evaluate and measure impairment of servicing assets as follows:
      (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.
      (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
      (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).
   h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

38. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset.
Fair Value

42. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

43. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

44. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

If It Is Not Practicable to Estimate Fair Value

45. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:
   a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred
   b. The amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

Securitizations

47. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

48. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to a special-purpose entity, commonly a trust. In “pass-through” and “pay-through” securitizations, receivables are transferred to the special-purpose entity at the inception of the
securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the special-purpose entity. In “revolving-period” securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the special-purpose entity uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

49. Beneficial interests in the qualifying special-purpose entity are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the qualifying special-purpose entity.

50. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

51. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract's value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

52. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

53. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor’s beneficial interest in the trust's assets. A sale does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

54. A securitization, carried out in one transfer or a series of transfers, may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does
depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

55. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

56. In other securitizations, a similar corporation transfers financial assets to a special-purpose entity in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies largely because the transferee is highly rated. Depending on facts and circumstances, the Board understands that those “single-step” securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 83). If the transferee fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

57. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those “two-step” structures:

a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide “excessive” credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.

b. Second, the special-purpose corporation transfers the assets to a trust, with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.

c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.
The Board understands that the “two-step” securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

58. A securitization by an entity subject to a possible receivership under procedures different from the U.S. Bankruptcy Code may isolate transferred assets from the transferor and its creditors even though it uses only one transfer directly to a special-purpose entity that issues beneficial interests to investors and the transferor provides credit or yield protection. For example, the Board understands that assets transferred by a U.S. bank are not subject to an automatic stay under Federal Deposit Insurance Corporation (FDIC) receivership and could only be obtained by the receiver if it makes the investors completely whole, that is, the investors must be paid compensation equivalent to all the economic benefits contained in the transferred assets, including bargained-for yield, before the FDIC could obtain those assets. Those limited powers appear insufficient to place the transferred assets within reach of the receiver. The powers of other receivers for entities not subject to the U.S. Bankruptcy Code, and of bankruptcy trustees in other jurisdictions, vary considerably, and therefore some receivers may be able to reach transferred financial assets, and others may not.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 1 - Consolidation of Majority-owned Subsidiaries
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 25 - Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- Issue Paper No. 46 - Accounting for Investments in Subsidiary, Controlled and Affiliated Entities
- Issue Paper No. 42 - Sale of Premium Receivables
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies
- Minutes of the March 26, 1990 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force

Generally Accepted Accounting Principles
- FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 87

Other Admitted Assets

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4) provides the definition of admitted and nonadmitted assets.

2. Current statutory accounting guidance for admitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P & C Accounting Practices and Procedures Manuals). Other admitted assets are specifically addressed in Chapter 8 of both manuals.


4. The purpose of this issue paper is to establish statutory accounting principles for admitted assets which are not specifically addressed in other issue papers.

SUMMARY CONCLUSION

5. The definition and accounting treatment for admitted assets is outlined in paragraphs 2 and 3 of Issue Paper No. 4 as follows:

For purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. These assets shall then be evaluated to determine whether they are admitted.

As stated in the Statement of Concepts, “The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet”, and are, therefore, considered nonadmitted. For purposes of the Codification, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting and is one which is:

a. Specifically identified within the Codification as a nonadmitted asset or
b. Not specifically identified within the Codification as an admitted asset.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The
asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, fixtures, and equipment, or supplies, can be expensed when purchased.

6. Consistent with paragraph 5, the following assets shall be considered admitted and shall be reported in accordance with Issue Paper No. 4. These admitted assets are not addressed in other issue papers.

**Collateral Loans**

7. Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment and meet the definition of assets as defined in Issue Paper No. 4, and, are admitted assets to the extent they conform to the requirements of this paper. The outstanding principal balance on the loan and any related accrued interest shall be recorded as an admitted asset subject to the following further limitations:

- **Loan Impairment -** Determination as to the impairment of a collateral loan shall be based on current information and events. When it is considered probable that any portion of amounts due under the contractual terms of the loan will not be collected the loan is considered impaired. The impairment shall be measured based on the fair value of the collateral less estimated costs to obtain and sell such collateral. The difference between the net value of the collateral and the recorded asset shall be written off in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5).

- **Nonadmitted Asset -** In accordance with Issue Paper No. 90 - Nonadmitted Assets (Issue Paper No. 90) collateral loans secured by assets that do not qualify as investments shall be nonadmitted. Further, any amount of the loan outstanding which is in excess of the permitted relationship of fair value of the pledged investment to the collateral loan shall be treated as a nonadmitted asset.

**Cash Value of Life Insurance Where the Reporting Entity is Owner and Beneficiary**

8. The cash value of life insurance policies where the reporting entity is the owner and beneficiary is similar to a cash deposit that is realizable on demand. As such, the cash value of a life insurance policy as of the date to which premiums have been paid, less any outstanding policy loans and surrender charges, shall be reported as an admitted asset.

**Receivables for Securities**

9. Sales of securities are recorded as of the trade date. A receivable due from the broker is established in instances when a security has been sold, but the proceeds from the sale have not been received. Unless the receivable for securities, other than a receivable arising from the sale of a security which was acquired on a “To Be Announced” (“TBA”) basis and which has yet to be actually received (see paragraph 12), meets the criteria noted in paragraph 11 below, the receivable for securities is an admitted asset to the extent it conforms to the requirements of this paper.

10. An evaluation shall be made in accordance with Issue Paper No. 5, to determine if there is an impairment. If, in accordance with Issue Paper No. 5, it is probable the balance, or any portion thereof, is uncollectible, any uncollectible receivable shall be written off and charged against income in the period the determination is made. If it is reasonably possible, but not probable, the balance or a portion of the balance is uncollectible and is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

11. Receivables for securities not received within 15 days from the settlement date shall be nonadmitted, and shall be classified as other than invested assets.
12. Receivables arising from the secondary sale of securities acquired on a TBA basis which have not yet been received by the seller in the secondary sale transaction, may be admitted until the security is exchanged for payment. TBA securities are originally purchased well in advance of the actual date of security issuance (frequently 90 days or more). Accordingly, secondary sales of securities so acquired may occur before the date of issuance. Sales of securities so acquired always include a provision that requires simultaneous delivery of the security and receipt of consideration. Upon the secondary sale, and prior to the actual receipt, of a security acquired on a TBA basis, the seller in the secondary sale transaction records a liability for the book value of the security thus sold and a receivable for the consideration reflected in the secondary sale transaction. Profits or losses emanating from the secondary sale transaction are recorded in the same manner as profits and losses emanating from any other sale transaction involving an investment.

**Other Amounts Receivable Under Reinsurance Contracts**

13. Amounts receivable from Servicemen’s Group Life Insurance (SGLI) or Federal Employees’ Group Life Insurance (FEGLI) pools and Federal Crop Insurance programs shall be reported as admitted assets.

**Guaranteed Investment Contracts**

14. Guaranteed Investment Contracts (GICs) purchased for investment purposes meet the definition of assets as defined in Issue Paper No. 4, and are admitted assets to the extent they conform to the requirements of this paper.

15. Purchases for which all contractual rights and ownership of the GIC result in an investment similar to a corporate bond shall be accounted for in accordance with the guidance in Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities.

16. An investment in a GIC payment stream is created when an intermediary purchases individual GICs, pools them, and sells the rights to the payment stream. These investments shall be reported as other long-term invested assets and shall be carried at amortized cost consistent with current statutory accounting.

17. If, in accordance with Issue Paper No. 5, it is probable that the carrying value of a GIC is not fully recoverable the investment shall be considered impaired. Accordingly, the cost basis of the investment shall be written down to the undiscounted estimated cash flows and the amount of the write down shall be accounted for as a capital loss. The new cost basis shall not be changed for subsequent recoveries in fair value.

**State Guarantee Association Promissory Notes**

18. State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company’s estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date. These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association.

19. Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement meet the definition of assets as defined in Issue Paper No. 4, are admitted assets to the extent they conform to the requirements of this paper, and shall be reported as a note receivable - other than invested assets.
DISCUSSION

20. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

a. With respect to the principles outlined in paragraph 7, collateral loans, the conclusion modifies current statutory accounting to require the evaluation and recording of an impairment in value of collateral loans. The method of evaluating and recording an impairment of value is consistent with FAS 114 which was adopted in Issue Paper No. 37 - Mortgage Loans.

b. With respect to the principles outlined in paragraph 11, receivables for securities, the conclusion modifies current statutory accounting to require that amounts not received within 15 days from the settlement date be nonadmitted. Issue Paper No. 4 states that an asset not readily available to satisfy policyholder obligations “shall be recorded as a nonadmitted asset and charged against surplus.” This is consistent with the Statement of Concepts, which states that an insurer’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.” Receivables for securities not received within 15 days from the settlement date are not considered readily available to satisfy policyholder obligations. Nonadmitting such receivables is also consistent with the conservatism concept of the Statement of Concepts.

c. With respect to the principles outlined in paragraph 17, guaranteed investment contracts, the conclusion modifies current statutory accounting to require the write-off of the portion of the asset not expected to be recoverable in accordance with Issue Paper No. 5.

d. Deposits in suspended depositories are considered nonadmitted assets as provided for in Issue Paper No. 90 as the amounts are not available to satisfy obligations to policyholders.

By requiring reporting entities to reflect impairments in the value of other admitted assets, the conclusions reached above are consistent with other issue papers on invested assets and specifically with Issue Paper No. 5. It is also more conservative than allowing a reporting entity to carry such impaired assets at a value in excess of that which may be realizable.

21. Current statutory accounting, as outlined in Chapter 8 of the P&C Accounting Practices and Procedures Manual, lists certain other assets that may be considered admitted assets should “sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets” exist. The examples provided are investments not considered to be prevalent or significant in industry and as such have not been included in this issue paper.

22. This issue paper adopts FTB 85-4 with modification. FTB 85-4 permits recognition of the cash surrender value of life insurance where the reporting entity is either the owner or beneficiary; whereas this issue paper requires that the reporting entity be both the owner and beneficiary. The cash values of life insurance policies meet the definition of assets defined in Issue Paper No. 4. When the reporting entity is not the owner of the policy, the cash value is not readily available to satisfy policyholder obligations and, therefore, is a nonadmitted asset.

23. The statutory accounting principles discussed above are consistent with the concepts of conservatism and recognition as outlined in the Statement of Concepts.
Conservatism

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

Recognition

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

Drafting Notes/Comments

- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets, discusses and outlines the appropriate treatment for the impairment of assets.
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities, discusses and outlines the appropriate recording and valuation of bonds.
- Issue Paper No. 37 - Mortgage Loans, discusses and outlines the appropriate recording and valuation of mortgage loans.
- Issue Paper No. 43 - Loan-backed and Structured Securities, discusses and outlines the appropriate recording and valuation of structured securities.
- Specific other admitted assets discussed in current statutory guidance excerpted below but not addressed in this issue paper are discussed in other issue papers.
- The NAIC Annual Statement Instructions regarding Receivables for Securities were adopted by the Blank's Task Force on October 14 and 15, 1996, to be effective beginning with 1998 Annual Statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Guidance

24. Chapter 8 of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

The various states specify certain assets, all or portions of, which may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of their state of domicile regarding other admitted assets.

Other admitted assets not discussed in this chapter include premium notes, reinsurance receivables, deferred and uncollected premiums, tax refunds, investment income due and accrued, and investment settlements pending. In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.

Collateral Loans

Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The various states regulate a life insurance company's investment in collateral loans. Generally, these regulations deal with the legal form of the assignment and the relationship of the market value of the pledged investment to the collateral loan. The amount of the loan in excess of the permitted relationship is customarily nonadmitted. Also, the collateral loan may be admissible only if the collateral itself is an authorized investment. In some
jurisdictions the collateral must be combined with the like securities held directly in determining if maximum investment limitations are being exceeded.

Guaranteed Investment Contracts (GICs)

Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.

Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as “Other Long-Term Invested Assets.”

The normal NAIC valuation procedures apply.

State Guarantee Association Promissory Notes

State guarantee associations have the statutory authority to reinsure any or all of the policies of an impaired or insolvent insurer. When this is done, the assuming carrier receives assets supporting the liabilities from the insolvent company’s estate and/or the responsible state guarantee association. If available, the state guarantee association transfers cash at the closing of the transaction. Promissory notes may be utilized in the event a guarantee association does not have the funds on hand or is unable to raise the funds by the closing date.

These promissory notes are essentially credit risk free because the notes are backed by all member insurers of an association. Funds to transfer the obligations via assumption reinsurance are obtained through assessments of solvent companies doing business in the state. If the maximum assessment allowed in any one year does not provide the necessary funds, additional assessments are made as soon thereafter as permitted by the guaranty association act.

Promissory notes issued by state guarantee associations taken by an insurance company in connection with funding an assumption reinsurance agreement shall be reported on the asset page, aggregate write-ins for other than invested assets line, as a note receivable–miscellaneous asset. Interest income shall be recorded in the Summary of Operations on the line entitled aggregate write-ins for miscellaneous income.

All promissory notes issued subsequent to the effective date of this guidance are subject to the following condition. The note must contain a clause which stipulates that in the event the state guarantee association fails to fulfill its obligations on the promissory note, the note and the related liabilities assumed by the insurance company will revert back to the state guarantee association.

This guidance is effective June 7, 1995.

The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

- Partnerships and Joint Ventures
- Amounts Due From Affiliated Companies
- Investments in Real Estate, Equipment and Other Assets Involving Leases
- Electronic Data Processing and Related Equipment
- Foreign Exchange Adjustment
- Deposits on Interest Rate Futures Contracts
- Amounts Receivable Relating to Uninsured Accident and Health Plans
- Derivative Instruments
- Insurance Futures and Insurance Futures Options
- Reverse Mortgages
Chapter 8 of the P & C Accounting Practices and Procedures Manual provides the following guidance:

The various states specify certain assets that may be admitted in determining statutory unassigned surplus. This chapter discusses some of the more common assets that are not discussed in other chapters. Each company should consult the laws and regulations of its state of domicile regarding limitations on admissibility and a more specific description of other admitted assets.

(a) The amount fairly estimated as recoverable on cash deposited in a closed bank or trust company is an admitted asset, if qualifying under the provisions of the various states prior to the suspension of such bank or trust company.

(b) Collateral loans are unconditional obligations for the payment of money secured by the pledge of an investment. The accounting is similar to that for mortgage loans. If the individual loan exceeds the excess of the permitted relationship of the market value of the pledged investment to the collateral loan, the excess is customarily treated as a nonadmitted asset. Also, the collateral loan is admitted only if the collateral itself is an authorized investment.

(c) Guaranteed Investment Contracts (GICs)

Absent specific statutory authority, the purchase of a guaranteed investment contract by an insurer for investment purposes, either directly or in the secondary market, should be considered the purchase of a direct corporate obligation of the issuer and such asset should be considered a bond and should be reported in Schedule D. This treatment applies only when the purchaser acquires all contractual rights and ownership of the guaranteed investment contract.

Absent specific statutory guidance, the purchase by an insurer of a payment stream in the secondary market should be reported in Schedule BA as “Other Long-Term Invested Assets.”

(e) Other invested assets that do not fall within the scope of previous chapters require sufficient subsidiary records to provide detail for the annual statement schedule of other invested assets. Examples of such assets which may be admissible:

1. Loan on or investments in oil and gas production payments, except those considered securities and listed in the schedule of stocks;
2. transportation equipment;
3. timber deeds;
4. mineral rights;
5. equipment trusts;
6. deposits relating to interest rate futures contracts;
7. any other admitted investment not clearly includable in other schedules.

The statutory method for accounting for lease and sale leaseback arrangements is governed largely by the form of the agreement to which the insurance company is party. The Financial Accounting Standards Board statements (FASB) 13, 28 and 66 are commonly used as guidelines where not in conflict with statutory accounting practices. Conservatism and policyholder protection are the objectives.

(o) Cash value of life insurance policies where the company is beneficiary is somewhat analogous to a cash deposit that is realizable on demand. The admissibility of the cash value of life insurance policies is based on general business practice. The admitted amount is the cash value as of the date to which premiums have been paid. (See Chapter 16 Other Income.)
The following paragraphs are addressed in other issue papers and as such the Chapter 8 discussion is not excerpted here.

(d) Partnerships and Joint Ventures
(f) Funds held by or deposited with reinsured companies
(g) Bills receivable taken for premiums
(h) Reinsurance recoverable on loss payments
(i) Federal income taxes recoverable
(j) Electronic Data Processing Equipment
(k) Interest, Dividends and Real Estate Income Due and Accrued
(l) Amounts due from affiliated companies
(m) Equities and deposits in pools and associations
(n) Amounts Receivable Relating to Uninsured Accident and Health Plans (See Chapter 13 Other Liabilities.)
(p) lease-purchase transactions

Derivative Instruments

Insurance Futures and Insurance Futures Options

Reverse Mortgages

26. The NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies specify that the following be classified as Other Than Invested Assets:

Amounts not received within 15 days of the end of the period that are due from brokers when a security has been sold, but the proceeds have not yet been received.

Generally Accepted Accounting Principles
27. Asset recognition is governed by CON 6. An asset is defined in paragraphs 25 and 26 of CON 6 as follows:

Assets are probable\textsuperscript{18} future economic benefits obtained or controlled by particular entity as a result of past transactions or events.

An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.

\textsuperscript{18} Probable is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, Accounting for Contingencies, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (Webster's New World Dictionary of the American Language, 2d college ed. [New York Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).
28. Accounting for the impairment of a loan is contained in FAS 114, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan--Income Recognition and Disclosures* (FAS 118). Pertinent excerpts are as follows:

8. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement.

13. When a loan is impaired as defined in paragraph 8 of this statement, a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. Regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The creditor may choose a measurement method on a loan by loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of collateral) is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premiums or discounts), a creditor shall recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense or by adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.

29. Accounting for purchases of life insurance is contained in FTB 85-4. Pertinent excerpts are as follows:

1. How should an entity account for an investment in life insurance?

1. The provisions of this Technical Bulletin apply to all entities that purchase life insurance in which the entity is either the owner or beneficiary of the contract, without regard to the funding objective of the purchase. Such purchases would typically include those intended to meet loan covenants or to fund deferred compensation agreements, buy-sell agreements, or postemployment death benefits. Purchases of life insurance by retirement plans that are subject to FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans, are not addressed by this Technical Bulletin.

Response

2. The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset. The change in cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period.

Effective Date And Transition

3. The provisions of this Technical Bulletin are effective for insurance policies acquired after November 14, 1985.

Appendix

Background

4. In November 1970, the AICPA issued an Accounting Interpretation entitled “Accounting for Key-Man Life Insurance.” That Accounting Interpretation identified the cash surrender value method as generally accepted accounting for purchases of life insurance. New
types of life insurance contracts, new provisions in traditional contracts, and changes in the insurance industry have led some to question the 1970 Accounting Interpretation. In October 1984, the AICPA's Accounting Standards Executive Committee (AcSEC) approved an Issues Paper entitled "Accounting for Key-Person Life Insurance." In the Issues Paper, AcSEC reaffirmed support of the cash surrender value method as the only generally accepted method. The AcSEC position differed from the position of the AICPA Insurance Companies Committee, which supported use of a different method in certain circumstances. AcSEC was concerned that diversity would develop in practice because of the difference between those positions and requested that the FASB consider the matter.

5. A premium paid by a purchaser of life insurance serves a variety of purposes. A portion of the premium pays the insurer for assumption of mortality risk and provides for recovery of the insurer's contract acquisition, initiation, and maintenance costs. Another portion of the premium contributes to the accumulation of contract values. The relative amounts of premium payment credited to various contract attributes change over time as the age of the insured party increases and as earnings are credited to previously established contract values.

6. An insurance contract is significantly different from most investment agreements. The various attributes of the policy could be obtained separately through term insurance and purchase of investment. The combination of benefits and contract values could not, however, typically be acquired absent the insurance contract. Continued protection from mortality risk and realization of scheduled increases in contract accumulation usually requires payment of future premiums.

7. The payment of insurance premiums may take a number of different forms. The insurance contract may be purchased through payment of a single premium, as opposed to the typical series of future premiums. Alternatively, the premium payments may be made through loans from the insurance company that are secured by policy cash surrender values. The pattern of premium payments is a decision that does not alter the underlying nature of the insurance contract.

Consideration of Comments Received on Proposed Technical Bulletin

8. A proposed Technical Bulletin, Accounting for Business-Owned Life Insurance, was released for comment on June 28, 1985. Forty-seven letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

9. Some respondents view the dominant objective of a life insurance contract to be investment. Subject to certain criteria evidencing an intent to continue the contract, they maintain that the contract meets the definition of an asset established in paragraph 19 of Concepts Statement 3, which states, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events" (footnote reference omitted). Those who hold this view suggested that such contracts should be accounted for using methods that result in reporting the investment in life insurance at amounts different from those stipulated in the contract.

10. This Technical Bulletin does not take that view. The current capacity to realize contract benefits is limited to settlement amounts specified in the contract. Additional amounts in excess of cash surrender value, which would be reported as assets under the various alternative accounting methods suggested, are created by future events, which typically include premium payments and earnings credited to contract amounts.

11. Paragraph 123 of Concepts Statement 3 discusses the occurrence of past events and the role of future events in the recognition of assets.
Since the transaction or event giving rise to the enterprise's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an enterprise's assets but have not yet become its assets. An enterprise has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future.

12. Some respondents asserted that reporting an insurance investment at its realizable value represents an accounting based on liquidation values. Those respondents suggested that the entity acquiring an insurance contract is, in many cases, economically or contractually committed to maintain the contract in force. They maintained that such a commitment virtually assures that benefits in excess of premiums paid would be realized and that the policy should be reported on a basis other than its cash surrender value.

13. This Technical Bulletin does not accept that view. The amount realizable under an insurance investment represents settlement values agreed to by an independent buyer and seller. The variety of yields and contract accumulation patterns available in the insurance marketplace provides the buyer and seller a variety of insurance and settlement options. There is no compelling justification to depart from the recording of such contracts based on agreed provisions. The commitment referred to by respondents is, in the staff's view, a commitment to ensure that assets are available to meet contractual obligations. The presence of such a commitment does not change the measurement of the asset that is expected to satisfy the obligation.

14. Some respondents asserted that policy features, most notably the business exchange rider, were significant factors in determining the proper accounting for the policy. The business exchange rider allows a company to use values in an existing policy to insure a different employee when the originally insured employee leaves the company. They maintain that this feature gives the employer the ability to transfer the contract freely and enhances the employer's ability to realize the future value of the investment. They further maintain that the increased probability of realizing future values should lead to the reporting of amounts in excess of cash surrender value.

15. This Technical Bulletin rejects that view. The business exchange rider is a significant development in the design of business insurance products and reduces additional policy costs if a covered employee leaves the company. Such a provision does not affect the realization of future benefits under the insurance contract, nor does it change the traditional underwriting decisions involved in insuring a new life. Instead, the provision only reduces the cost of obtaining those benefits by allowing a new employee to be insured without the costs that are typically associated with obtaining a new policy.

**RELEVANT LITERATURE**

**Statutory Accounting Practices and Procedures**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8
- NAIC Annual Statement Instructions for Life and Accident and Health and for Property and Casualty Insurance Companies
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 26 - Bonds, excluding Loan-backed and Structured Securities
- Issue Paper No. 37 - Mortgage Loans
- Issue Paper No. 68 - Business Combinations and Goodwill
- Issue Paper No. 90 - Nonadmitted Assets
Generally Accepted Accounting Principles
- FASB Statement No. 114, *Accounting by Creditors for the Impairment of a Loan*
- Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*
- FASB Emerging Issues Task Force No. 88-5, *Recognition of Insurance Death Benefits*
- FASB Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance*

State Regulations
- No additional guidance obtained from state statutes or regulations.
Mortgage Guaranty Insurance

SUMMARY OF ISSUE

1. Mortgage guaranty insurance protects a lender against loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. It differs from other types of property and casualty insurance in that coverage is long-term, and in most cases premiums are level and paid monthly. Most states require issuers of mortgage guaranty contracts to be monoline insurers and impose limitations on the aggregate amount of risk insured based on geographic territories. Additionally, states may limit mortgage guaranty insurers to reinsure with only selected reinsurers.


3. Although GAAP guidance for mortgage guaranty insurance is provided in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), certain aspects of accounting for mortgage guaranty insurance contracts are specifically excluded from FAS 60. The aspects of FAS 60 not applicable to mortgage guaranty insurance relate to premium revenue, claims cost recognition, and acquisition costs.

4. To fill this void in GAAP, the AICPA exposed a draft statement of position in October 1980. The statement of position proposed that premiums be recognized evenly over the anticipated policy term. Costs of acquiring business such as salaries and commissions, generally would be deferred and amortized as the related premiums were earned. Losses on claims, including expenses of settlement, such as appraisal fees, generally would be recognized as of the initial default date.

5. The statement of position was never issued and there has been no further GAAP guidance relating to accounting for premium revenue and claims cost recognition and acquisition costs relating to mortgage guaranty insurance contracts.

6. Although there is no promulgated GAAP guidance, common practice is to recognize revenue as follows:

   a. For single premium plans, revenues are recognized over the policy life in relation to the expiration of risk;

   b. For annual premium plans, revenues are earned on a pro rata basis over the applicable year;

   c. For monthly premium plans, revenues are earned either in the month received or the month due.
7. Losses and loss adjustment expenses are generally recognized on the default date regardless of when claims are reported to the insurer.

8. The purpose of this issue paper is to establish statutory accounting principles for recording premium revenue and the liability for unpaid losses and loss adjustment expenses that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Premium Revenue Recognition
9. Written premium shall be recorded in accordance with Issue Paper No. 53 - Property and Casualty Contracts - Premiums (Issue Paper No. 53). Premium revenue shall be earned as follows:
   a. For single premium plans, revenues shall be earned over the policy life in relation to the expiration of risk;
   b. For annual premium plans, revenues shall be earned on a pro rata basis over the applicable year;
   c. Additional first year premiums on nonlevel policies shall be deferred and amortized to income over the anticipated premium paying period of the policy in relation to the expiration of risk;
   d. Initial renewal premiums that are higher than subsequent renewals shall be deferred and amortized over the remaining anticipated premium paying period in a manner consistent with additional first year premiums (i.e., in relation to the expiration of risk);
   e. For monthly premium plans, revenues shall be earned in the month to which they relate.

10. When the anticipated losses, loss adjustment expenses, commissions and other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, contingency reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the excess deficiency with a corresponding charge to operations. Commission and other acquisition costs need not be considered in the premium deficiency analysis since they have previously been expensed. If an insurer utilizes anticipated investment income as a factor in the premium deficiency calculation, disclosure of such shall be made in the financial statements.

Unpaid Losses and Loss Adjustment Expense Recognition
11. Unpaid losses and loss adjustment expenses shall be recognized in accordance with Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses (Issue Paper No. 55). For mortgage guaranty insurance contracts, the date of default shall be considered the incident that gives rise to a claim as discussed in Issue Paper No. 55. If a claim is ultimately presented, the date of default shall be considered the loss incurred date.

12. The process for estimating the liability shall include projections for losses that have been reported as well as those that have been incurred but not reported. The estimates shall be made based on historical data, trends, economic factors, and other statistical information including paid claims, reported losses, insurance in force statistics, and risk statistics.

13. Real estate and mortgages are acquired by mortgage guaranty insurers to mitigate losses. These assets shall be shown on the balance sheet at the lower of cost or net realizable value, net of
encumbrances. Any gains or losses from the holding or disposition of these assets shall be recorded as a component of losses incurred. Any rental income or holding expenses shall be included in loss adjustment expenses.

Contingency Reserve
14. In addition to the unearned premium reserve, mortgage guaranty insurers shall maintain a liability referred to as a statutory contingency reserve. The purpose of this reserve is to protect policyholders against loss during periods of extreme economic contraction. The annual addition to the liability shall equal 50% of the earned premium from mortgage guaranty insurance contracts and shall be maintained for ten years regardless of the coverage period for which premiums were paid. With commissioner approval, when required by statute, the contingency reserve may be released in any year in which actual incurred losses exceed 35% of the corresponding earned premiums. Any such reductions shall be made on a first-in first-out basis. Changes in the reserve shall be recorded directly to surplus.

Disclosures
15. Mortgage guaranty insurers shall make all disclosures required by other issue papers within the codification, including but not limited to the requirements of Issue Paper No. 55 - Disclosures of Accounting Policies, Risks & Uncertainties, and Other Disclosures.

DISCUSSION
16. This issue paper is not consistent with current statutory guidance as follows:

a. Premium Recognition
   i. The P & C Accounting Practices and Procedures Manual distinguishes premiums for high risk policies from other policies. The conclusions reached in this issue paper make no such distinction because the concept is implicit in the requirement to earn revenues in relation to the expiration of risk.

   ii. Certain states dictate by statute that a specific formula, table, or earnings curve be utilized to determine earned premiums. To the extent that the requirements are based on the exposure period and the relative risk during that period, they are consistent with the concepts set forth in this issue paper.

   iii. The Mortgage Guaranty Insurance Model Act provides no specific guidance on premium revenue recognition other than the requirement to establish an unearned premium reserve. The method of establishing such reserve is based on regulation of the state of domicile.

   iv. Current statutory guidance has no requirement to establish a premium deficiency reserve.

b. Contingency Reserve

The contingency reserve may be recorded through income or directly to surplus. This issue paper requires changes in the reserve to be recorded through surplus.

   i. The Model Act requires that the contingency reserve shall be computed as an amount equal to 50% of the unearned premium after the establishment of the unearned premium reserve. This issue paper requires the establishment of a contingency reserve based on earned premium. Consistent with the Model Act, this issue paper provides that reserves can be reduced if Commissioner approval is obtained. However, Commissioner approval of a reserve reduction will only be considered as a viable means of reducing a reserve
where the reporting entity can clearly demonstrate to the commissioner that the existing reserves are excessive.

17. Issue Paper No. 53 requires recognition of premium on a pro-rata basis over the period of exposure except when specific issue papers require different methods because the level of risk may vary significantly over the exposure period. Losses related to mortgage guaranty policies can occur over an exposure period which extends for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period and tends to peak in the earlier years. This issue paper provides guidance for premium recognition that is based on the exposure period of the contract and the underlying risk. Recognizing premiums over the exposure period and in relation to the underlying risk allows insurers to determine methods appropriate to the contracts they write versus requiring insurers to use methods that may not appropriately reflect such risks. Premiums collected on an annual payment plan may not be sufficient to cover the risk in early years. Subparagraph 9 b. requires annual premiums to be earned over the applicable year and does not permit an insurer to accrue premiums which may be collected in future years. Additional first year premiums and initial renewal premiums that are higher than subsequent renewals may be front loaded to expedite the collection of premium. Subparagraphs 9 c. and 9 d. require an insurer to defer the revenue and amortize it in relation to the expiration of risk.

18. The changes referred to in paragraph 16 were made to improve consistency in reporting among insurers that offer mortgage guaranty contracts as well as to improve consistency in reporting between reporting periods. This is consistent with the Statement of Concepts which states:

Consistency

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

19. This issue paper expands current statutory guidance with respect to the recognition of losses. The P & C Accounting Practices and Procedures Manual provides guidance that losses shall be recognized when they occur. This issue paper defines the occurrence date as the date of default of a loan.

20. This issue paper is inconsistent with Issue Paper No. 22 which requires rental income on property to be recorded as investment income whereas this issue paper requires recognition of rental income as a reduction of loss adjustment expense.

21. The inconsistency between mortgage guaranty insurers and all other insurers in the reporting of all real estate obtained through foreclosure and in the recognition of rental income is reflective of the nature of the risks underwritten. Losses on real estate incurred by mortgage guaranty insurers can be viewed as resulting from underwriting activities and not investing activities. Because mortgage guaranty insurers are generally required to be monoline companies, and are prohibited from investing in real estate, the inconsistency with all property casualty insurers will not hinder evaluation of the mortgage guaranty insurers results.

22. The contingency reserve does not meet the definition of a liability which is set forth in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets. However, it is consistent with the “ultimate objective of solvency regulations” as stated in the Statement of Concepts. This states:

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the ultimate objective of solvency regulation is to ensure that policyholder, contract holder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety.

Additionally, recording the contingency reserve as a liability is consistent with the Statement of Concepts which states:

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

23. This issue paper is inconsistent with the guidance set forth in the AICPA exposure draft for mortgage guaranty insurance for the following reasons:

a. This issue paper requires that acquisition costs shall be accounted for in accordance with Issue Paper No. 71 - Policy Acquisition Costs and Commissions rather than deferred as indicated in the exposure draft.

b. Paragraph 14 of this issue paper requires insurers to establish a contingency reserve. The AICPA exposure draft has no such requirement.

24. This issue paper is consistent with Issue Paper No. 55 which requires the ultimate cost of all known and unknown claims as well as related settling costs to be recorded when an insured event occurs.

Drafting Notes/Comments
- U.S. Mortgage Guaranty Tax and Loss Bonds and Contingency Reserve (for tax purposes, the Mortgage Guaranty Account) are addressed in Issue Paper No. 83 - Accounting for Income Taxes.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
25. Appendix A, Mortgage Guaranty Insurance Accounting Principles Supplement, of the P & C Accounting Practices and Procedures Manual provides the following guidance with respect to accounting for mortgage guaranty insurance: (only pertinent excerpts are included)

Insured Risk

The nature of the insured risk is influenced by certain factors which set the mortgage guaranty insurance product in some respects apart from other types of insurance.

1. Exposure Period

The period of exposure for a particular risk is significantly longer for mortgage insurance than for other property/liability insurance products. The exposure period for mortgage insurance can run for the term of the mortgage; however, the average policy life is seven years. The policy is terminated when the mortgage obligation is satisfied or the lender elects to cancel or not renew the policy.

Mortgage insurance is renewable at the option of the insured and at the renewal rate quoted when the policy commitment was issued. Disability income and certain life and
health insurance products are other policies written with similar terms regarding renewal rate and cancellation.

In contrast to mortgage insurance, most property/liability products need not be renewed by the insurer at the expiration of the policy. The fact that mortgage insurance is guaranteed renewable at a definite rate is one of the factors necessitating the establishment of a contingency reserve. In effect, this reserve protects not only against catastrophic economic events, but also against a decrease in the quality of the insurance portfolio because of adverse selection at each renewal period.

2. **Losses**

The insured peril—the default of a borrower—arises from the credit risk associated with mortgage loans. The frequency of loss is strongly influenced by economic conditions. The likelihood of individual default is further increased if the property has deteriorated since a borrower in financial difficulty will be less able to sell the property at a price sufficient to discharge the mortgage.

Mortgage insurance losses can be divided into three categories:

(a) Normal losses associated with regular business cycles, interruptions in the borrower’s earning power and random errors made in evaluating the insured’s willingness or ability to meet mortgage obligations.

(b) Defaults caused by adverse local economic conditions.

(c) Widespread defaults caused by a severe depression in the U.S. economy.

The possible magnitude of loss contemplated in the last category has no analogy in any other private property/liability line of insurance.

3. **Loss Incidence**

Losses are incurred over an exposure period which can, as previously discussed, run for the term of the mortgage. The pattern of normal loss incidence is not uniform over the exposure period. The loss incidence peaks in the earlier years.

When a loan has been delinquent two or four months, the mortgage insurance policy requires the lender to notify the insurer. Further, the lender agrees to institute foreclosure proceedings six to nine months from the date of delinquency. Foreclosure can require an additional 18 months which could mean a considerable delay between the delinquency and the date of the claim. Without adverse economic conditions, most delinquencies do not result in a claim. Once a claim is presented, payment normally is made within one or two months and ultimate loss costs can be known relatively quick. An exception is the case where an insurer chooses to take the title to the property and sell it. Thus, reporting of losses and loss payments occur within the period that title is held by the insurer.

**Pool Insurance**

In addition to insuring mortgage loans on an individual basis (primary insurance), mortgage guaranty insurance is provided on pools of mortgage loans. Typically, such insurance supports mortgage-backed securities or group sales. Unlike other pool or group products, each loan is individually underwritten.

Pool insurance may be provided on loans that are already insured by primary insurance, in which case the pool insurance provides an additional level of coverage, or it may be provided on loans without primary insurance (usually loans with loan-to-value ratios below 80%). Generally, pool insurance provides 100% coverage and includes a stop-loss limit of liability which may range
from 5% to 20% of the initial aggregate principal balance. Because of regulatory requirements in some states, pool insurance usually uses participating reinsurance arrangements to limit the exposure of any one mortgage insurer of a pool of loans to 25% of each mortgage insured.

Pool insurance policies are not cancelable by the insurer except for nonpayment of premium. These policies are generally written on mortgage pools having terms of up to 30 years. However, for all practical purposes, it is expected that the life of each pool will be considerably shorter than 30 years and will result in average policy life of 8 to 12 years. This compares to an individual policy which has an average term of 7 years.

In the case of default, the insurer has the same options as with individual insured mortgage loans. However, pool insurance loss payments are reduced by any settlements under primary insurance and subject to the stop-loss limit.

Three kinds of mortgage-backed securities which use pool insurance are described as follows:

1. **Mortgage-Backed Bonds**
   
   Issued by banks, savings and loan associations and other mortgage lenders as a general obligation of the issuing institution. These bonds are collateralized by a pool or mortgages and have a stated rate of return and maturity date.

2. **Mortgage Revenue Bonds**
   
   Issued by state and local housing authorities to support housing affordability for targeted income groups.

3. **Mortgage Pass-Through Certificates**
   
   Issued by banks, savings and loan associations, mortgage bankers and others providing an undivided interest in a pool of mortgages with principal and interest payment passed to the certificate holder as received.

**Special Regulatory Requirements for Mortgage Insurers**

1. **Risk Ratio**
   
   Since the inception of the private mortgage insurance industry in 1957, private mortgage insurers have been required to operate within a 25-to-1 ratio of risk to surplus, a ratio which many state insurance commissioners have determined to be prudent for the protection of lenders. For the purposes of arriving at this risk ratio, the regulatory authorities have defined “risk” as the total amount of exposure (percentage coverage) relating to the insurance in force, and “surplus” as policyholders’ surplus (capital, paid-in surplus, and unassigned surplus) plus the contingency reserve.

2. **Statutory Contingency Reserve**
   
   This is a special statutory reserve designed to protect policyholders against loss during a period of extreme economic contraction. By law, insurers must set aside 50 cents of each premium dollar earned and maintain the contingency reserve for a period of ten years, regardless of the length of coverage of the particular policy for which premium was paid. In most states, with the approval of the insurance commissioner, the contingency reserve may be reduced when losses in a calendar year exceed 35% of earned premiums (20% in some states).
REAL ESTATE

Generally, real estate owned by mortgage guaranty insurance companies consists of two types; (a) properties occupied by the company; or (b) real estate owned as a result of claim settlement. Real estate owned and held for use by the company is accounted for in the same manner as other fire and casualty companies.

Claims Settlement Costs

The cost of real estate acquired in the settlement of claims is similar in computation to that acquired by other insurers through a foreclosure process. Generally the cost of real estate acquired through foreclosure or in settlement of claims includes the outstanding principal balance of the mortgage loan on the date of foreclosure, plus accumulated interest, unpaid real estate taxes, insurance premiums, and all other costs necessary to obtain clear title and place the property in good repair.

If a property acquired in settlement of a claim is rented prior to disposal, the rental income received on such property is recorded as a reduction of loss adjustment expenses. Generally, expenditures for ordinary repairs is necessary to maintain the property in good operating condition, utilities, and real estate taxes paid after the acquisition of the property are recorded as loss adjustment expenses. Expenditures for major improvements made to the property are generally capitalized.

Statement Value

The statement value of real estate acquired in settlement of claims is generally accounted for at its net realizable value (the amount of cash, or its equivalent, expected to be realized upon disposal, net of costs such as maintenance and selling expenses required to be incurred prior to sale). In lieu of writing down real estate when realizable value is less than cost, a loss reserve may be established as a liability.

The excess of acquisition cost over realizable value on property disposed of at a later date is recorded to losses paid for the period in which the reduction in realizable value has been determined.

LOSSES

Recognition

The underlying goal of estimating unpaid losses is to have unpaid losses reflect the liability outstanding for losses that have been incurred as of the report date. Losses are recognized as they occur and not as they are reported to the company. Because of this basis of recognition, unpaid losses are grouped as (1) reported and (2) incurred but not reported (IBNR). Reported losses are those incurred losses of which the mortgage insurer has been notified by the lender through delinquent loan reporting and/or filing a claim for payment. The incurred but not reported losses are those losses that have occurred that have not been reported to the company.

Valuation

1. Estimation of Reported Losses Unpaid

Unpaid losses are estimated based on predictions of loss frequency and loss severity. These estimates are based on historic data, trends, economic information, and other statistical information.
Loss frequency and loss severity estimates are made for three separate categories:

(a) Insured loans that have resulted in the conveyance of property which remains unsold

(b) Insured loans in the process of foreclosure

(c) Insured loans in default

2. Incurred But Not Reported Losses

With the reported and unpaid loss category of the reserve representing the liabilities for reported claims and delinquencies, the mortgage insurer must also record a liability for losses that are incurred but not reported.

Estimates of loss frequency and loss severity for incurred but not reported losses are made based on historic data, trends, economic factors, and other statistical data in relation to paid claims, the reserve for reported losses unpaid, insurance in force statistics, and risk statistics.

CONTINGENCY RESERVE

The contingency reserve, as described in several statutes, is established and maintained for the purpose of protecting insureds against the effect of adverse economic cycles. The reserve is variously described as a premium reserve, or loss reserve, or is not specifically described. The annual contribution to the contingency reserve is deductible in the computation of the federal income tax liability as described in the chapter on “Federal Income Taxes.”

In most jurisdictions, the annual addition to the contingency reserve liability is 50% of earned premium. One jurisdiction requires that the reserve contribution be based upon the loan amount of outstanding mortgages insured or 50% of earned premiums, whichever is higher. In another jurisdiction, the annual addition applicable to the mortgage pool insurance business segment is based upon insured risk. Each annual addition to the contingency reserve must be maintained for 10 years before being released, except that releases are permitted (on a first-in, first-out basis) at an earlier date should actual losses exceed established percentages of earned premiums as set forth in the statutes.

There are two predominant practices being used to report the effect of contingency reserve transactions. “Practice One” is to report changes to the reserve in the income statement; “Practice Two” is to report changes as a direct adjustment to surplus.

Under Practice One, the liability for the contingency reserve is included in loss reserves and the net addition to (or deduction from) the contingency reserve liability is reported as a deduction from (or addition to) underwriting income in the income statement.

Under Practice Two, the liability for contingency reserves is reported as a separate line item among other liabilities. The net addition to (or deduction from) the contingency reserve liability is not recorded in the income statement, but rather it is reported as a direct adjustment to surplus.

Prior to computing financial ratios and results for an insurer: (1) underwriting income comparisons between insurers using the differing practices will require an adjustment to account for the differing treatments of additions to (or deductions from) the contingency reserve, and (2) as with the risk ratio calculation, the contingency reserve must be added to policyholders’ surplus. In addition, if appropriate, statutory net income should be adjusted for any federal income tax consequences arising from the purchase of tax and loss bonds (see Federal Income Taxes chapter). These adjustments may require information not found in the annual statement.
UNEARNED PREMIUMS

There are a variety of statutory accounting methods used by mortgage guaranty insurers to determine the earned and unearned portion of premiums written. The rate at which premiums are earned differs based on type of policy, the loan-to-value ratio of the mortgage and the policy term (single premium versus annual renewals).

Certain states dictate through statute or regulation a specific formula or table to be used for the above policy types. Special attention is placed on single premium (multiple year) policies and on the “excess risk” portion of the initial annual premium.

Renewal Premiums, Annual Premiums and Level Premiums

Renewal premiums and annual premiums on policies with a loan-to-value of 90% or less are earned on a monthly pro rata basis using the 13-month method (sometimes called the 1/24 method because 1/24 is earned in each of the first and last months, and 1/12 in each of the other 11 months). This method assumes that the effective dates of policies are spread evenly throughout the month and that the average date is the 15th.

Level premium policies are handled the same as the above. Thus, a three-year policy payable in three equal annual installments is booked the same way as the three successive one-year policies.

Annual Premiums on High-Risk Policies

In some jurisdictions, the portion of the first year’s premium which exceeds twice the annual renewal rate is earned on a deferred basis. (These premiums usually relate to mortgages with loan-to-value ratios in excess of 90%.)

Single Premiums

Single premiums are typically recognized on a deferred basis and then earned according to various statutorily mandated earnings curves.

LOSS AND LOSS ADJUSTMENT EXPENSES INCURRED

Mortgage guaranty insurance accounting differs from property insurance accounting in that if real estate is acquired, salvage value is recognized. If a property is in claims settlement, the difference between the cost of the property and its estimated net realizable value is recorded as loss expense at the date of acquisition. Further, in some jurisdictions, net additions to the contingency reserve are reported as part of incurred losses (see chapter on Contingency Reserve).

26. The Mortgage Guaranty Insurance Model Act provides the following guidance: (only pertinent excerpts included)

Section 16. Reserves

A. Unearned Premium Reserves

A mortgage guaranty insurance company shall compute and maintain an unearned premium reserve as set forth by regulation adopted by the commissioner of insurance.

B. Loss Reserve

A mortgage guaranty insurance company shall compute and maintain adequate case basis and other loss reserves which accurately reflect loss frequency and loss severity
and shall include components for claims reported and for claims incurred but not reported, including estimated losses on:

(1) Insured loans which have resulted in the conveyance of property which remains unsold;

(2) Insured loans in the process of foreclosure;

(3) Insured loans in default for four (4) months or for any lesser period which is defined as default for such purposes in the policy provisions; and

(4) Insured leases in default for four (4) months or for any lesser period which is defined as default for such purposes in policy provisions.

C. Contingency Reserve

Each mortgage guaranty insurance company shall establish a contingency reserve out of net premium remaining (gross premiums less premiums returned to policyholders net of reinsurance) after establishment of the unearned premium reserve. The mortgage guaranty insurance company shall contribute to the contingency reserve an amount equal to fifty percent (50%) of such remaining unearned premiums. Contributions to the contingency reserve made during each calendar year shall be maintained for a period of one hundred and twenty months (120), except that withdrawals may be made by the company in any year in which the actual incurred losses exceed thirty-five percent (35%) of the corresponding earned premiums, and no such releases shall be made without prior approval by the commissioner of insurance of the insurance company's state of domicile.

If the coverage provided in this act exceeds the limitations set forth herein, the commissioner of insurance shall establish a rate formula factor that will produce a contingency reserve adequate for the added risk assumed. The face amount of an insured mortgage shall be computed before any reduction by the mortgage guaranty insurance company's election to limit its coverage to a portion of the entire indebtedness.

D. Reinsurance

Whenever a mortgage guaranty insurance company obtains reinsurance from an insurance company which is properly licensed to provide such reinsurance or from an appropriate governmental agency, the mortgage guaranty insurer and the reinsurer shall establish and maintain the reserves required in this chapter in appropriate proportions in relation to the risk retained by the original insurer and ceded to the assuming reinsurer so that the total reserves established shall not be less than the reserves required by this chapter.

E. Miscellaneous

(1) Whenever the laws of any other jurisdiction, in which a mortgage guaranty insurance company subject to the requirement of this act, is also licensed to transact mortgage guaranty insurance, require a larger unearned premium reserve or contingency reserve in the aggregate than that set forth herein, the establishment of such larger unearned premium reserve or contingency reserve in the aggregate shall be deemed to be in compliance with this chapter.

(2) Unearned premium reserves and contingency reserves shall be computed and maintained on risks insured after the effective date of this chapter as required by Sections 16A and 16C. Unearned premium reserves and contingency reserves on risks insured before the effective date of this chapter may be computed and maintained as required previously.
Section 17. Regulations

The commissioner shall have the authority to promulgate rules and regulations deemed necessary to effectively implement the requirements of this chapter.

Generally Accepted Accounting Principles
- No specific GAAP guidance obtained.

OTHER SOURCES OF INFORMATION

27. The AICPA Exposure Draft on mortgage guaranty insurance provides the following guidance.

Conclusions with respect to earning premium

19. Single premiums should be earned on a pro rata basis throughout the policy term, or on a declining basis if the amount of coverage significantly declines during the policy term. Annual premiums should be earned on the same basis. Level annual premiums should be earned on a pro rata basis over the policy term (usually one year). Additional first-year premiums on nonlevel policies, that is, the difference between first-year and level renewal premiums, should be deferred and amortized to income over the anticipated premium-paying period of the policies in relation to total anticipated premium receipts excluding the additional first-year premiums. If the dollar amount of coverage significantly declines during the anticipated premium-paying period, the additional first-year premium should be amortized to income in relation to anticipated coverage. If the initial renewal premium rate is higher than subsequent renewal premium rates, the excess premiums should be deferred and amortized to income over the remaining anticipated premium paying period of the policies in the same manner as the additional first-year premiums (this does not apply to policies with reduced premiums in later years, such as the tenth year or later). Level renewal premiums and the portion of the first-year premium equal to the level renewal premium should be earned on a pro rata basis over the policy term (generally one year). When significant differences between anticipated and actual renewal premiums occur, the predetermined amortization of additional first-year premiums should be adjusted to reflect actual experience.

Conclusions with respect to premium deficiencies

36. When anticipated losses and loss adjustment expenses, maintenance expenses and unamortized deferred acquisition costs exceed unearned premiums and estimated renewal premiums on existing policies, a provision for the anticipated premium deficiency should be provided. Premium deficiencies should be determined by reasonable groupings of business based on line of business or geographical area. (Premium deficiencies should be recognized by writing off any unamortized deferred acquisition costs to the extent required. If the deficiencies are more than the unamortized deferred acquisition costs, a separate liability should be provided for the excess deficiency).

37. In addition, companies that consider anticipated investment income in computing premium deficiencies should disclose the fact in their financial statements, together with the effects on the financial statements.

Conclusions with respect to recording claims

49. Losses should be accrued as of the initial default date, however, if a company can demonstrate that another date is more appropriate, such as 60 or 90 days after the initial default losses may be accrued as of that date.

50. In addition, companies that discount loss or loss adjustment expense reserves (see paragraphs 56 through 59) should disclose that fact in their financial statements, together with the effects on the financial statements.
51. No conclusion has been reached regarding whether loss reserves should be discounted; that is, whether the time value of money should be considered in determining loss reserves. This issue, as it applies to all insurance companies, is being considered separately by the AICPA Insurance Companies Committee.

RELEVANT LITERATURE

Statutory Accounting
- Accounting Practices and Procedures Manual for Property and Casualty Insurers, Appendix A
- The Mortgage Guaranty Insurance Model Act
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 22 - Leases
- Issue Paper No. 53 - Property Casualty Contracts - Premiums
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses
- Issue Paper No. 65 - Property and Casualty Contracts
- Issue Paper No. 71 - Policy Acquisition Costs and Commissions
- Issue Paper No. 77 - Disclosure of Accounting Policies, Risks & Uncertainties, and Other Disclosures

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises

State Regulations
- No additional guidance obtained from state regulations or laws.

Other Sources of Information
- AICPA Exposure Draft on Mortgage Guaranty Insurance
- California Insurance Code §§ 12640.01 to 12640.18 (1961/1993)
- Wisconsin Administrative Code § 3.09 (1992)
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Statutory Issue Paper No. 89

Separate Accounts

STATUS
Finalized March 13, 2000

Type of Issue:
Life Specific

SUMMARY OF ISSUE


2. GAAP guidance for separate account contracts requires investments to be reported at market value except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets are generally reported in accordance with FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises (FAS 60), as amended by FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114), FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115) and FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of (FAS 121). GAAP guidance for separate account contracts requires policy reserves or liabilities to be established using the balance that accrues to the benefit of the policyholder.

3. The purpose of this issue paper is to provide guidance on accounting and reporting for separate accounts in both the general account and separate account statement, consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Introduction

4. Separate accounts are used to fund variable life insurance, variable annuities, modified guaranteed annuities and modified guaranteed life insurance, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options.

5. Assets held in separate accounts are owned by the insurer. All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account and, except for modified guaranteed annuities, modified guaranteed life insurance, and separate accounts established and filed to provide guaranteed benefits, investment performance is generally not guaranteed by the insurer. Charges relating to contract guarantees, administration, and investment management are deducted from separate accounts.
General Account Reporting

6. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and shall be accounted for as transactions of the general account.

7. For those separate account contracts classified as life contracts under Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force, premiums and annuity considerations shall be recorded as income in the Summary of Operations of the general account, and as transfers to premiums and considerations in the separate account statement. Deposit-type contracts shall be recorded in the general account in accordance with Issue Paper No. 52 - Deposit-Type Contracts. Charges (e.g., fees associated with investment management, administration, and contract guarantees) assessed on the separate accounts, as well as the net gain from operations of the separate account shall be recorded as income in the Summary of Operations of the general account. Expenses relating to investment management, administration, and contract guarantees pertaining to separate account operations, as well as benefits and surrenders incurred on behalf of separate account contracts classified as life contracts, net transfers between separate accounts, commissions, and premium taxes (if any) shall be recorded as expenses in the Summary of Operations of the general account.

8. The general account shall include the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated. Changes in the surplus of the separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, shall be charged or credited directly to the unassigned funds (surplus) of the general account.

9. Where a variable annuity contract or variable life insurance contract contains a guaranteed minimum death benefit, any reserve liability for such death benefit provision shall be recorded and held in the general account based on the reserving guidance in paragraphs 24 and 25. Any differences between the benefit paid and the separate account asset value of the contract shall be charged against or credited to the general account in its net gain from operations.

10. Separate account surplus may not become negative. For example, for separate account contracts which have annuitized (i.e., contracts in the payout stage), lower than expected mortality on variable annuity contracts containing mortality guarantees may cause a deficiency in the investment funds underlying the contract reserves. Thus the general account incurs an expense and the separate account realizes revenue to cover this deficiency, if necessary. Conversely, excess funds from higher than expected mortality will result in mortality gains that are included in the Summary of Operations of the separate account and are ultimately recorded as equity in net income from separate account operations as discussed in paragraph 7.

11. For variable products, separate account surplus created through the use of the commissioners’ reserve valuation method (CRVM), commissioners’ annuity reserve valuation method (CARVM), or other reserving methods, shall be reported by the general account as an unsettled transfer from the separate account. The net change on such transfers shall be included as a part of the net gain from operations in the general account.

12. Surplus funds transferred from the general account to the separate account, commonly referred to as seed money, and earnings accumulated thereon shall be reported as surplus in the separate accounts until transferred or repatriated to the general account. The transfer of such funds between the separate account and the general account shall be reported as surplus contributed or withdrawn during the year.
13. If an Asset Valuation Reserve (AVR) is required for investments held by separate accounts, it is combined with the general account AVR and accounted for in the general account financial statements (see Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve (Issue Paper No. 7)). The criteria for determining when an AVR is required for separate accounts are described in paragraph 17 of this issue paper.

Separate Account Reporting

14. The separate accounts annual statement is concerned with the flow of funds related to investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account. As a result, the separate account statement shall report only the assets, liabilities, and operations of the separate account and shall not include general account expenses related to investment management, administration, or contract guarantees pertaining to separate account operations which are recorded in the general account.

15. The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes) and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized and unrealized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations. When the contract provides for such, expenses and taxes associated with the separate account investment operations shall be deducted in the determination of net investment income. Deposits and withdrawals on deposit-type contracts shall be recorded in the Summary of Operations. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (e.g., fees associated with investment management, administration, and contract guarantees), and federal income taxes relating to the separate account are recorded as expense transfers to the general account in the Summary of Operations. The net change in aggregate reserves relating to separate account contracts is reported as an expense in the Summary of Operations.

16. Assets supporting fund accumulation contracts (GICs), which do not participate in underlying portfolio experience, with a fixed interest rate guarantee, purchased under a retirement plan or plan of deferred compensation, established or maintained by an employer, will be recorded as if the assets were held in the general account. Assets supporting all other contractual benefits shall be recorded at market value on the date of valuation, or if there is no readily available market, then in accordance with the valuation procedures in the applicable contract.

Separate Account AVR and IMR Reporting

17. An AVR is generally required for separate accounts when the insurer, rather than the policyholder/contractholder, suffers the loss in the event of asset default or market value loss. An AVR is required unless:

   a. The asset default or market value risk is borne directly by the policyholders, or

   b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

18. Assets supporting traditional variable annuities and variable life insurance generally do not require an AVR because the policyholders/contractholders bear the risk of change in the value of the assets. However, an AVR is required for that portion of the assets representing the insurer’s equity interest in the investments of the separate account (e.g., seed money).

19. Assets supporting typical modified guaranteed contracts, market value adjusted contracts, and contracts with book value guarantees similar to contracts generally found in the general account do require an AVR because the insurer is responsible for credit related asset loss.
20. Certain separate accounts are also required to maintain an Interest Maintenance Reserve (IMR). The IMR requirements for investments held in separate accounts are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

21. An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at market value. For example, separate accounts for traditional variable annuities or variable life insurance do not require an IMR because assets and liabilities are valued at market value.

22. If an IMR is required for investments held by separate accounts, it is kept separate from the general account IMR and accounted for in the separate accounts statement.

23. The AVR and IMR shall be calculated and reported in accordance with the Annual Statement Instructions.

Policy Reserves
24. Statutory policy reserves shall be established for all contractual obligations of the insurer arising out of the provisions of the insurance contract. Where separate benefits are included in a contract, a reserve for each benefit shall be established as required in Appendix A-820. These statutory policy reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums. Statutory policy reserves meet the definition of liabilities as defined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). The actuarial methodologies referred to in the following paragraph meet the criteria required for reasonable estimates in Issue Paper No. 5.

25. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendix A-250, A-270, A-255, A-585, A-588, A-620, A-820 A-822, and the actuarial guidelines found in Part 9 of the NAIC Financial Examiners Handbook. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820 shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market.) Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

Other Liabilities
26. The separate account shall accrue as a liability, subject to contractual provisions, amounts payable, including, but not limited to:

- Charges for investment management, administration, and contract guarantees
- Investment expenses
- Investment taxes, licenses, and fees (Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes) are usually paid directly by the separate account but may be transferred to the general account for payment)
- Federal income taxes
- Unearned investment income
- Net transfer due to (from) the general account
- Remittances and items not allocated
- Payable for investments purchased
- Net adjustments in assets and liabilities due to foreign exchange rates
Seed Money
27. When a new separate account is initiated, the insurer may make a temporary transfer of surplus funds commonly referred to as seed money to the separate account. Such funds and earnings accumulated thereon shall be reported as surplus in the separate accounts statement until transferred or repatriated to the general account. The transfer of such funds to and from the separate account shall be reported as surplus contributed or withdrawn during the year.

Disclosures
28. The general account financial statement shall include a description of the general nature and characteristics of the various kinds of separate accounts business conducted by the company and included in the company’s Separate Accounts Statement. For each grouping (as detailed in paragraph 29), the following shall be disclosed:

a. Premiums, considerations or deposits received during the year;

b. Reserves by the valuation basis of the investments supporting the reserves at the financial statement date. List reserves for separate accounts whose assets are carried at market value separately from those whose assets are carried at amortized cost/book value;

c. Reserves by withdrawal characteristics, i.e., whether or not the separate account is subject to discretionary withdrawal or market value adjustment, or to withdrawal at book value with or without surrender charge;

d. Reserves for asset default risk, as described in paragraph 15 b., that are recorded in lieu of AVR.

29. Separate accounts shall be addressed in the following groupings (which are the same as those used for risk-based capital):

a. Separate Accounts with Guarantees:

i. Indexed separate accounts, which are invested to mirror an established index which is the basis of the guarantee;

ii. Nonindexed separate accounts, with reserve interest rate at no greater than 4% and/or fund long-term interest guarantee in excess of a year that does not exceed 4%;

iii. Nonindexed separate accounts, with reserve interest rate at greater than 4% and/or fund long-term interest guarantee in excess of a year that exceeds 4%.

b. Nonguaranteed Separate Accounts—Variable separate accounts, where the benefit is determined by the performance and/or market value of the investments held in the separate account. Include variable accounts with incidental risks, nominal expense, and minimum death benefit guarantees.

30. Provide a reconciliation of the amount reported as transfers to and from separate accounts in the Summary of Operations of the separate accounts statement and the amount reported as net transfers to or from separate accounts in the Summary of Operations of the general accounts statement.
DISCUSSION

Statutory Guidance

31. Consistent with Issue Paper No. 7, this issue paper adopts current statutory guidance for AVR and IMR for Life and Accident and Health insurance companies.

32. The statutory accounting principles outlined in the conclusion above regarding accounting and reporting for separate account life and annuity contracts are consistent with current statutory accounting, except for separate account deposit-type contracts which shall be accounted for consistent with the guidance in Issue Paper No. 52 - Deposit-Type Contracts. The statutory accounting principles outlined in the conclusion above are consistent with the Statement of Concepts which states:

Conservatism

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

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

Consistency

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

Recognition

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

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

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

Drafting Notes/Comments
- Issue Paper No. 50 addresses Classifications and Definitions of Insurance or Managed Care Contracts In Force.
- Issue Paper No. 51 addresses Life Contracts.
- Issue Paper No. 52 addresses Deposit-Type Contracts.
- This issue paper references the Purposes and Procedures Manual of the SVO. The guidance for AVR/IMR was subsequently moved to the Annual Statement Instructions for Life and Accident and Health Insurance Companies. SSAP No. 56 references the Annual Statement Instructions.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE (ONLY PERTINENT EXCERPTS ARE INCLUDED BELOW)

Statutory Accounting
34. The Life/A&H Accounting Practices and Procedures Manual, Chapter 25, Separate Accounts, provides the following guidance with respect to separate accounts:

**SEPARATE ACCOUNTS**

A life insurance company is authorized by state statutes to establish separate accounts and to allocate thereto, pursuant to agreements, amounts paid to it. Separate accounts may be used:

1. to provide for annuities, whether ultimately payable in guaranteed fixed amounts or variable amounts or both;
2. to provide life insurance where the benefits, premiums, or both, are payable on a variable basis and for which the reserves vary according to the investment experience of the underlying separate account;
3. to accumulate funds which are intended to be applied at some later time to provide life insurance, whether fixed or variable or both; or
4. to accumulate, or hold in a separate account, proceeds applied under settlement or dividend options.

All investment income and capital gains and losses (whether or not realized) from assets allocated to a separate account are, in accordance with applicable agreements, credited to or charged against the separate account policyholders. Investment performance is generally not guaranteed by the insurance company.

Assets allocated to separate accounts are owned by the insurer and the insurer is not a trustee by reason of the separate accounts. However, if permitted or required by state law, a separate agreement may provide that the portion of the assets of the separate account equal to the reserves and other contract liabilities of the separate account shall not be chargeable with liabilities arising out of any other business of the insurer.
State statutes generally provide that amounts allocated to a separate account and accumulations on those amounts may be invested and reinvested without regard to any requirements or limitations imposed upon an insurer by the investment statutes which apply to insurers generally.

Some statutes provide that to the extent that the insurer’s reserve liability, with regard to benefits guaranteed as to dollar amounts and duration and funds guaranteed as to principle amount or stated rate of interest, is maintained in a separate account, a portion of the assets of the account at least equal to the reserve liability with regard to these benefits shall be invested in accordance with the investment statutes of the domiciliary state. These assets shall be reported separately and valued in accordance with the rules otherwise applicable to the insurer generally.

Assets allocated to a separate account, other than those provided for guaranteed benefits as described above, are valued at their market value on the date of valuation, or if there is no readily available market, then in accordance with the applicable contract.

The reserve or liability under a contract with a separate account provision is usually determined on the basis of the market value of the assets in the separate account.

Separate accounts may be used to fund individual variable life insurance, individual variable annuities, group variable life insurance, group variable annuities and various group contracts under pension or other employee benefit plans where funds are held in a separate account essentially as a liability. The financial experience on these separate accounts is reported in the annual statement of separate accounts business.

**Relationships of the Separate Accounts Annual Statement and the Life and Accident and Health Annual Statement**

Accounting for separate account business involves both the general account of a company and the separate accounts. The separate accounts annual statement is concerned primarily with the investment activities of the separate accounts and with the flow of funds from and to the general account. Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account fund and are accounted for as transactions of the general account; the expenses incurred on account of these functions are reported in the life and accident and health annual statement. Thus, premiums and considerations and benefit payments on separate accounts business are reported respectively in the premiums and annuity considerations exhibit and the policy contract claims exhibit of the life and accident and health statement. Similarly the policy exhibit and the exhibit of annuities and supplementary contracts with life contingencies in the life and accident and health statement includes variable annuity contracts.

Expenses incurred on contracts with separate accounts (other than direct investment expenses) are generally reported in the general account. Fees related to these expenses are charged to the separate accounts policyholders. Federal income taxes and taxes incurred on separate account investments are reported in the separate account statement, but other taxes, i.e., taxes on consideration, are reported in the general account. Where a variable annuity contract contains a guaranteed minimum benefit such as return of consideration paid on death within a specified period, any excess of the benefit paid over the separate account asset value of the contract would customarily be a charge against the general account. Any reserve liability for such death benefit provisions is normally carried in the general account.

Under a variable annuity contract containing mortality guarantees which are reserved in the general account, when lighter than expected mortality causes a deficiency in the investment funds underlying the contract reserves, the general account must transfer funds to the separate account. Conversely, excess funds form higher than expected mortality are transferred to the general account. As a general rule, the total statement value of the assets held in a separate account must be equal to (never less than) the total separate account reserve liability of the
contracts participating in the separate account. If mortality gains are allowed to accumulate in the separate account, these accumulations may be reported as surplus.

Overview of the Flow of Funds and Accounting

Gross purchase payments received are reported in the life and accident and health statement. In the case of a variable life or variable annuity contract, the net purchase payment is transferred immediately to the separate account. In most cases, the purchase payment transferred will be net (gross minus loading).

If a net purchase payment on a variable annuity is not accounted for as consideration received, it should be transferred to the separate account as an “annuity deposit” or “purchase payment reserve” (or similar term). The loading might be treated as a consideration for accounting purposes. At such time as the accumulation is to be applied to purchase an annuity or supplementary contract, the entire accumulation (net purchase payments plus investment income) is transferred to the general account to be accounted for as consideration received. Appropriate taxes on the total amount of such consideration (including all accumulated investment income) are deducted before the remaining funds are either transferred back to the separate account as consideration for a variable annuity or supplementary contract or used to buy a fixed annuity or supplementary contract in the general account. The return of the fund or surrender or death prior to maturity is generally reported as a return of purchase payments. This is the equivalent of the redemption by the issuer of shares in a mutual fund, which a variable annuity in the accumulation stage closely resembles.

In the employee benefit area, separate accounts may be used to fund part or all of unallocated pension funds during the accumulation phase and group variable annuities in the payout phase. Amounts of consideration or purchase payments are received from the employer through the general account and transferred to the separate account after deducting any loading for expenses, etc. Funds withdrawn for the purchase of fixed or variable annuities are transferred to the general account where they are reported as considerations received. Applicable taxes are deducted prior to purchase of an annuity for a retiring employee.

Under certain arrangements, employee benefit funds may be put into a separate account to be accumulated until withdrawn to be used for various purposes. Such funds would not be reported as income; amounts transferred from the general account are reported net of amount returned.

Generally, considerations, purchase payments, deposits, etc., received by a separate account are recorded on a cash basis.

Life and annuity benefits and payments on supplementary contracts are paid through the general account with funds transferred from the separate account. The liability for any benefits transferred but unpaid at year-end would be carried by the general account.

Some variable annuity contracts, during the accumulation period, permit the contract holder to transfer funds between the separate account and the general account. In order to avoid inflating the income reported in either or both accounts, special provision is made for transferring these reserves between the general account and the separate accounts.

Individual variable annuity contracts usually contain guarantees for mortality and expense assumptions. Charges for these guarantees, and for administrative and investment management expenses, are usually expressed as an annual percentage of the asset value of the contract and may also include an amount per contract. Such charges may be calculated and deducted from the separate account on a daily, weekly, or monthly basis—generally the same interval at which the separate account is valued. Group contracts with separate account provisions may have similar arrangements.
Charges, when deducted from the separate account asset values, are usually transferred to the
general account. Charges deducted but not yet transferred are usually carried as a liability in the
separate accounts statement. Some companies prefer to accumulate the mortality and expense
guarantee charges in the separate account as surplus.

Investment expenses incurred may be payable directly by the separate accounts or may be
incurred by the general account to be reimbursed by the separate accounts. Investment
expenses incurred by the general account on behalf of the separate accounts may be reported in
the life and accident and health statement. These investment expenses may be deducted from
this statement, on a line by line basis, and entered in the same way in the separate accounts
statement; or they may be deducted as a single negative item in the life and accident and health
statement and entered as a summary item in the separate accounts statement.

Investment taxes such as real estate taxes, licenses and fees (excluding federal income taxes)
are usually paid directly by the separate accounts but may be transferred to the general account
for payment. Federal income taxes are not paid directly by the separate accounts. The amount of
federal income tax estimated as incurred is transferred to the general account.

A reserve for future federal income taxes is provided for in the separate accounts statement. The
purpose of this item is to recognize that the amount of capital gains credited to contract holders at
any time is the net after deducting capital gains taxes which would be payable under the
assumption that all assets were disposed of at that point in time. This deduction is reflected in the
increase in the liability item, “Reserves for future federal income taxes.” Note that a decrease in
unrealized capital gains would cause a decrease in this reserve.

When a new separate account is initiated, the company may make a temporary transfer of
surplus funds commonly referred to as “seed money” to the separate account. Such funds are
reported as surplus in the separate accounts statement and the transfer of such funds to and
from the separate account would be reported as surplus contributed or withdrawn during the
year. The rules and regulations of various states restrict the sale, exchange, or transfer of assets
between the general and separate accounts.

Separate accounts, as reported in the statement blank, would normally not develop a gain from
operations because (a) gains or losses arising from mortality and expenses are reflected in the
general account; (b) investment expenses and taxes are deducted from investment gains and
losses; and (c) investment gains and losses after expenses and taxes are absorbed in the
increase in reserve liabilities. A gain from operations could arise from earnings on contributed
surplus maintained in a separate account or when a company does not transfer mortality and
expense guarantee charges out of the separate accounts. Note that a separate account surplus
can never be permitted to become negative.

Mortality gains and losses can be handled in either of two ways.

1. If the separate accounts are being reported on a zero gain from operations basis, then
any net gain from mortality should be transferred to the general account, or, if a loss, a
transfer of an offset amount should be made from the general account. In either case, on
the aggregate write-in lines under “Other transfers from the separate accounts” in the
Summary of Operations page of the separate accounts statement, appropriately
captioned, e.g., "Other transfers (net)," may be used. An offset to a mortality loss would
be a negative entry.

2. If mortality gains or losses are to be permitted to flow through to the gain from operations
and the surplus account is to be kept at zero, then a counterbalancing entry must appear
in the surplus account. Since surplus in a separate account cannot be permitted to be
negative, a counterbalancing contribution to surplus from the general account must be
made whenever surplus would otherwise become negative.
The analysis of increase in reserves illustrates how the year-end reserves reported are developed from the operations of the separate account. It follows in a general way the corresponding analysis in the life and accident and health statement.

Separate Account Reporting in the Life and Accident and Health Statement

Transfer transactions affect both the life and accident and health and the separate accounts statements but to avoid duplicate detailed reporting, and also to avoid complicating the life and accident and health statement, the details of the transfer are shown only in the separate accounts statement. Aggregate transfer items are netted and shown in the inserts on the liabilities page and in the Reconciliation of Cash and Invested Assets in the separate accounts statement. These same net totals would be included as single line entries on appropriate pages of the life and accident and health statement.

The asset page of the life and accident and health statement provides for the entry of the totals from the asset page of the separate accounts statements. The liabilities page of the life and accident and health statement provides for two entries from the separate accounts statements. The first entry shows the amount of transfers to the separate accounts due or accrued. This item is entered on a net basis so that if there is an amount due from the separate accounts to the general accounts, the net of the two will be entered as a negative item. The reason for this treatment is that a more normal treatment, under which an amount due the general account from the separate account is entered as an asset in the life and accident and health statement, would inflate both the assets and the liabilities totals of the life and accident and health annual statement. The second entry on the liabilities page of the life and accident and health statement is for the total liabilities entry from the separate accounts statement.

The Summary of Operations and Analysis of Operations by Lines of Business of the life statement provides for entry of net transfers to separate accounts--there is no one source for this figure in the separate accounts statement. Items relating to separate accounts may also appear as direct entries to surplus.

35. The Separate Accounts Annual Statement Blank Instructions provide the following guidance with respect to separate accounts:

GENERAL

The instructions for completing the general account are to be followed to the extent applicable. This supplement provides additional instructions that are unique to the Separate Accounts Blank as well as some that differ from those for the Life and Accident and Health Blank. Where there is a conflict with the Life Blank's instructions use these instructions. The reporting date must be plainly written or stamped at the top of all pages, exhibits and schedules (and duplicate schedules) and also upon all inserted schedules and loose sheets.

The separate accounts statement reports only the operations of the separate accounts themselves. It assumes that the administration of the contracts is reflected in the general account statement—hence, administrative expense does not appear in the Separate Accounts Statement, premiums and considerations are net of loading, and the expenses and taxes are those associated with the separate account investment operations.

Receipts other than income from investments are handled as a transfer from the general account. Similarly, amounts providing for the payment of benefits, including surrender benefits and various other payments, appear as transfers from the separate account to the general account. When eventually paid, these items are reported in the general account statement. The assets and liabilities are strictly those which arise from the operations of the separate accounts themselves, i.e., policy and contract reserves and items related to the making of investments, including investment expenses and taxes due or accrued. Unpaid transfers due the general account, such as surplus, contractual benefits, or contractual charges, would also appear on the liability page.
36. The June 5, 1995 minutes of the Separate Accounts Working Group of the Accounting Practices and Procedures (EX4) Task Force provide the following guidance with respect to separate accounts:

1. Accounting for Separate Account Surplus

Peter Storms (Arthur Andersen) provided a summary of the work accomplished to date relative to accounting for separate account surplus. Mr. Storms noted that the interested parties group continues to support its original recommendation.

Tomoko Stock (Calif.) stated that California opposes the recommendation of the interested parties group. Specifically, they oppose the reporting of fee income, generated through the use of Commissioners Annuity Reserve Valuation Method (CARVM), being allowed to flow through the general account’s income statement on an accrual basis. Ms. Stock suggested that this treatment of fee income inflates current income and has a potential impact on stockholder dividends. The California position is to recognize the income as it is realized.

Jack Gies (Conn.) noted that surplus created through the use of CARVM is a book item, not a cash item. He also noted that the income earned from separate account fees is fairly certain to be realized either through mortality and expense charges or through surrender charges.

Working group members noted that the accounting treatment being proposed assumes that CARVM is being applied in an accurate and prudent manner.

Alan Close (Northwestern Mutual Life) stated that his recommendation included a different balance sheet presentation from that recommended by the interested parties group, with an approach that stresses the appropriate measure of assets and liabilities. He noted, however, that his recommendation supported the income statement presentation recommended by the interested parties group.

Bill Carroll (American Council of Life Insurance—ACLI) noted that the ACLI’s committee on statutory accounting met in May 1995 and voted to support the recommendation of the interested parties.

After being duly moved and seconded, the working group voted to adopt the accounting treatment for separate account surplus which requires that separate account surplus created through the use of CARVM be recorded as an unsettled transfer from the separate accounts; that separate account seed money and earnings accumulated thereon, be reported in the separate accounts until repatriated; and that the net gain from separate accounts operations be included in the general account summary of operations. Blank proposals to effect this accounting treatment will be prepared for submission prior to July 1, 1995.

Ms. Stock noted that the adopted accounting treatment will include parenthetical entries on the balance sheet to specifically identify amounts in the transfer account that are related to the use of CARVM.

The working group noted, that in adopting this accounting treatment, it will be necessary for the Risk-Based Capital Task Force to revise the life risk-based capital report to include the separate accounts transfer balance with the separate accounts surplus when applying the risk-based capital charge. Blaine Shepherd (Minn.) stated that he would report this issue to the Risk-Based Capital Task Force.

37. Chapter 16, Asset Valuation Reserve and Interest Maintenance Reserve, in the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies states the instructions for calculating the AVR and IMR are contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies.
38. Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies of the Purposes and Procedures of the Securities Valuation Office of the NAIC contains the following excerpts (note that this is not quoted in its entirety):

This Section applies to all life insurance companies and fraternal benefit societies. The Section describes in general terms, principles of the calculation for Interest Maintenance Reserve (IMR) for realized gains and losses from fixed income investments and the Asset Valuation Reserve (AVR) on all invested assets held by a company. [Refer to the NAIC’s Life and Health Annual Statement Instructions for specific reporting guidance.] The IMR is a single component reserve. The AVR breaks down into two major components and each component has two subcomponents:

The Default Component--

(i) Other Than Mortgage Subcomponent
(ii) The Mortgage Subcomponent

The Equity Component--

(i) The Common Stock Subcomponent
(ii) The Real Estate and Other Invested Assets Subcomponent

(A) Interest Maintenance Reserve (IMR). This reserve applies to realized capital gains and losses net of tax on short-term and long-term fixed income investments. These gains and losses are from the disposal of investments as reported in Schedule D, Part 4 for long-term bonds and preferred stock; Schedule DA, short-term bonds; Schedule DB, interest rate hedges; Schedule B, mortgage loans; or Schedule BA for other fixed income investments. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold. The IMR also applies to certain liability gains/losses related to changes in interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the liability released.

The current year’s IMR is equal to:

The beginning balance
plus (minus) the realized capital gains (losses) net of tax attributed to interest rate changes
plus (minus) realized liability gains (losses) net of tax attributed to interest rate changes
less an amortization amount

(a) Interest Related Realized Capital Gains and Losses:

The gains and losses are to be reported net of applicable capital gains taxes allocated in accordance with an insurers established policy.

A realized gain or loss on each debt security and mortgage backed security will be an interest related gain or loss if the debt security’s beginning NAIC rating did not change by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. With respect to Class One Bond Mutual Funds, “realized capital gains and (losses)” include any capital gains and losses realized by the Company, whether from sale of the Fund or capital gains distributions by the Fund. However, where the gain on a convertible bond or preferred stock sold while “in the money” is included in IMR, the expected maturity date is defined as the next conversion date. “In the money” is defined to mean that the number of shares available currently or at next conversion date, multiplied by their current market price, is greater than the statement value of the convertible asset. However, for a convertible bond or convertible preferred stock purchased while its conversion value exceeds its
par value, any gain or loss realized from its sale before conversion must be excluded from the IMR and included in the AVR. Conversion value is defined to mean the number of shares available currently or at next conversion date, multiplied by the stock’s current market price. The holding period is defined as the period from the date of purchase to the date of sale. For end of period classification, the most recent available rating should be used. For debt securities acquired before January 1, 1991, the debt security’s rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security’s gain or loss should not be included in this reserve if the debt security rating was ever a “6” during the holding period.

Preferred stock that did not have an NAIC/SVO rating classification of “PSF-4”, “PSF-5”, “PSF-6” or “P-4”, “P-5” or “P-6” at any time during the holding period should be reported as interest related gains and (losses) in the Interest Maintenance Reserve if the stock’s beginning NAIC/SVO rating did not change by more than one classification at the end of the holding period.

For preferred stocks acquired before January 1, 1993, the holding period is assumed to have begun in December 31, 1992.

For Class One Bond Mutual Funds, the holding period is defined as one calendar year to expected maturity.

Determination of IMR gain or loss on multiple lots of the same securities should follow the underlying accounting treatment in determining the gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss.

Losses recognized on loan-backed bonds and other structured securities that have a negative effective yield at the date of valuation should be treated as realized losses and included in the reserve as if the security had been sold and the loss considered an interest rate loss. If the security is valued using the prospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of anticipated future cash flows of the security is less than the current book value of the security at the date of valuation. If the security is valued using the retrospective adjustment methodology, a negative effective yield occurs when the net undiscounted sum of actual and anticipated cash flows is less than the original cost of the investment.

Capital gains and losses net of capital gains tax on mortgage loans, where interest is not more than 90 days past due, not in process of foreclosure, not in course of voluntary conveyance, or have not had restructured terms over the prior two years will be classified as an interest rate gain or loss. Prepayment penalties recorded as capital gains on mortgage securities are also considered to be due to interest rate changes.

Realized gains and losses on fixed income investments recorded on Schedule BA should be classified as an interest gain or loss if they are in the nature of those defined for bonds, preferred stocks and mortgages.

Realized gains and losses, net of capital gains tax, on derivative investments arising out of transactions entered into solely for the purpose of altering the interest rate characteristics of the company’s assets and/or liabilities should be allocated to the IMR and amortized into income over the remaining life of the assets or liabilities associated with the derivative instruments. Gains or (losses) on dollar repurchase agreements that are traded for the fee have no IMR (or AVR) impact because they are treated as financings.

If during the course of the year, the SVO removes the classification of “class one” from a Class One Bond Mutual Fund, the company shall not report capital gains or (losses) on this schedule. Any such removal of the “class one” classification will cause the Fund to be reported as common stock on the applicable schedules.
(b) Liability gains/(losses) Subject to IMR Amortization

1) Reinsurance -

The interest rate related gain or loss (net of taxes) associated with the sale, transfer or reinsurance of a block of liabilities must be credited or charged to the IMR and then amortized into income provided:

1. the portion of the block reinsured represents more than 5% of a company’s general account liabilities (Page 3, Line 26 of the Annual Statement),

2. the transaction is irrevocable and is to a non-affiliate and

3. the transaction was completed in the current year.

A company may elect to use a lower materiality threshold than the 5% specified in Item 1 above provided that such election is applied consistently to all transactions subsequent to the election, and the election is conveyed to the Insurance Department of the state of domicile. Once a threshold is elected, it can only be changed with the prior approval of the Insurance Department of the state of domicile.

The amount of the gain or loss that is interest rate related and its IMR amortization should be determined using the following procedure for the portion of the block sold, transferred or reinsured.

1. Identify the IMR balance and future amortization arising from the past and present dispositions of the assets associated with the block of liabilities.

2. Identify the IMR balance and future amortization that would result if the remaining assets associated with the block of liabilities were to be sold.

3. Define the interest rate related gain or (loss) net of taxes to be the negative of the sum of the IMR balances determined in steps 1 and 2. The future amortization of the gain or loss is the negative of the sum of the amortization determined in steps 1 and 2.

The associated assets are the assets allocable to the reinsured block of business for the purposes of investment income allocation. If the company has not been tracking the investment income of the block, it should retrospectively identify the assets using procedures consistent with its usual investment income allocation procedures. The associated assets are not necessarily the same as the assets transferred as part of the transaction.

2.) Market Value Adjustments

Material gains or losses resulting from market value adjustments on policies and contracts backed by assets that are valued at book, including the marginal tax impact, should be captured by the IMR and amortized in a manner consistent with the determination of the market value adjustment. A gain or loss is considered material if it is in excess of both .01% of liabilities and $1,000,000. The amortization schedules should be determined in a manner consistent with the determination of associated market value adjustment.

(d) Amortization into income:

There are two acceptable methods for accumulating and calculating the amortization schedule. A company can select either the seriatim method or the grouped method for calculating
IMR amortization. Although a company is not precluded from changing methods on a prospective basis, the overriding consideration is the reasonableness of the amortization. However, once a method is selected for a particular year’s capital gains, the amortization is locked in and cannot be changed (at least not without the specific approval of the commissioner).

1. Seriatim Method—The amount of each capital gain or (loss), net of capital gains tax, amortized in a given year using the seriatim method is the excess of the amount of income that would have been reported in that year, had the asset not been disposed of, over the amount of income that would have been reported had the asset been repurchased at its sale price. The capital gains tax associated with or allocated to each gain or (loss) should be amortized in proportion to the amortization of the gain or (loss).

For loan-backed bonds and structured securities that are valued using currently anticipated prepayments use an amortization schedule developed using the anticipated future cash flows of the security sold consistent with the prepayment assumptions that would have been used to value the security had the security been purchased at its sale price.

The seriatim calculation on an asset by asset basis is the desired approach, but since a seriatim approach may impose an administrative burden on some companies, each company may use the method employed by that company to amortize interest related capital gains and losses among lines of business and policyholders in accordance with the investment income allocation process as approved by the state insurance department.

2. Grouped Method—A company may use a standard “simplified method” by which the capital gains and (losses), net of capital gains tax, are grouped according to the number of calendar years to expected maturity.

The groupings are based on the years to expected maturity as of the date of sale.

- 0 calendar years to expected maturity,
- 1 calendar year to expected maturity,
- 2 to 5 calendar years to expected maturity,
- 6 to 10 calendar years to expected maturity,
- 11 to 15 calendar years to expected maturity,
- 16 to 20 calendar years to expected maturity,
- 21 to 25 calendar years to expected maturity,
- over 25 calendar years to expected maturity.

The amortization schedule for the current year is the sum of the gains and losses by maturity groupings times the appropriate factor for the current and future years. The maturity groupings and factors are found in 6(B)(j).

The presence of sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:

For fixed income instruments with fixed contractual repayment dates and amounts (including bonds, preferred stock, callable or convertible bonds and preferreds), the expected maturity is defined as the contractual retirement date that produces the lowest amortization value for Annual Statement purposes (lowest internal rate of return or “yield to worst”). Potential retirement dates include all possible call dates, and the contractual maturity date where a convertible bond or convertible preferred stock is sold while its conversion value exceeds its statement value and the gain is included in IMR, the expected maturity date is defined as the next conversion date. Conversion value is defined to mean the number of shares of common stock available currently or at the next conversion date, multiplied by the stock’s current market price. When the instrument’s contractual terms include scheduled sinking fund payments, amortization schedules, expected prepayments, and adjustable interest rates complicate the determination of the number of calendar years to expected maturity. The expected maturity date is:
payments of fixed amounts, an additional calculation of yield to average life should be included in the analysis where average life is defined as the date at which the instrument is 50% repaid. For puttable instruments, where the exercise option rests with the investor, expected maturity is the put or maturity date that produces the highest internal rate of return. For Class One Bond Mutual Funds, use one calendar year to expected maturity. For perpetual instruments, the expected maturity is 30 years from the current date.

However, where a callable bond purchased at a premium is called or sold after the expected maturity date, there should be no amortization of the call premium or interest rate related gain or loss and the gain or loss should be taken into income immediately. Similarly there should be no amortization of any interest rate related gain or loss arising if a convertible bond or preferred stock is disposed of after the expected maturity date.

For liability gains and losses included in the IMR, amortization should be determined in a manner consistent with the determination of associated market value adjustment or assets transferred.

“Calendar years to expected maturity” means the calendar year of expected maturity minus the calendar year of sale date.

For purposes of the grouped method, the following additional assumptions are applicable:

- For fixed income investments, other than residential mortgages and residential mortgage pass-throughs, without a maturity date or sinking fund schedule, a maturity date 30 years from the current year should be used.

- For loan-backed bonds and other structured securities that are valued using currently anticipated prepayments use the remaining weighted average life of principal and interest payments consistent with the prepayment assumptions that would have been used to value the security had the security been repurchased at its sale price.

(e) Separate Accounts

Interest Maintenance Reserve (IMR) requirements for investments reported in the separate accounts statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in the separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book, but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the separate accounts statement, it is kept separate from the general accounts IMR and accounted for in the separate accounts statement. For further details see rules as explained in Sec (6) (A) (f).

(f) Negative IMR

A negative IMR balance may be recorded as a negative liability in either the general account or the separate accounts statements of a company only to the extent that it is covered or offset by a positive IMR liability in the other statement.
The following information is presented to assist in determining the proper accounting:

<table>
<thead>
<tr>
<th>General Account IMR Balance</th>
<th>Separate Accounting IMR Balance</th>
<th>Net IMR Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive</td>
<td>Positive</td>
<td>Positive (See rule a)</td>
</tr>
<tr>
<td>Negative</td>
<td>Negative</td>
<td>Negative (See rule b)</td>
</tr>
<tr>
<td>Positive</td>
<td>Negative</td>
<td>Positive (See rule c)</td>
</tr>
<tr>
<td>Positive</td>
<td>Negative</td>
<td>Negative (See rule d)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Positive (See rule e)</td>
</tr>
<tr>
<td>Negative</td>
<td>Positive</td>
<td>Negative (See rule f)</td>
</tr>
</tbody>
</table>

Rules:

a) If both balances are positive, then report each as a liability in its respective statement.

b) If both balances are negative, then no portion of the negative balances is allowable as a negative liability in either statement. Report a zero for the IMR liability in each statement. If there is any disallowed negative IMR balance in the general account statement, record the disallowed portion as a positive amount for Disallowed IMR in a write-in line for assets not admitted in Exhibit 14. If there is any disallowed negative IMR balance in the separate accounts statement, determine the change in the disallowed portion and make a direct charge or credit to the surplus account for the Change in Disallowed IMR.

c) If the general account balance is positive, the separate accounts balance is negative and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the separate accounts statement.

d) If the general account balance is positive, the separate account balance is negative, and the combined net balance is negative, then the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the separate accounts statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the separate accounts statement.

e) If the general account balances is negative, the separate account balance is positive, and the combined net balance is positive, then all of the negative IMR balance is allowable as a negative liability in the general account statement.

f) If the general account balance is negative, the separate account balance is positive, and the combined net balance is negative, the negative amount not covered by the positive amount is not allowable. Report only the allowable portion as a negative liability in the general account statement, and follow the instructions in b) above for handling the disallowed portion of negative IMR balances in the general account statement.

(B) Asset Valuation Reserve (AVR). This reserve shall apply to the specific risk characteristics of all the invested asset categories excluding cash, policy loans, premium notes, collateral loans and income receivables. The specific assets to be included in each subcomponent are:
The Default Component

The Other Than Mortgage Loans Component shall include all fixed income investments that are corporate or governmental unit obligations, excepting those listed in subsection (g) as exempt from the AVR reserve, preferred stock and loan backed securities as reported in Schedule D - Part 1 and Part 2 -- Section 1, and Schedule DA, and counterparty exposure arising from derivative transactions as reported in Schedule DB - Part E - Section 1.

The Mortgage Loans Subcomponent shall include all farm, commercial, residential mortgages as reported in Schedule B and Schedule DA.

The Equity Component

The Common Stock Subcomponent shall include all affiliated and unaffiliated common stock investments as reported in Schedule D, Part 2--Section 2.

The Real Estate and Other Invested Asset Subcomponent shall include all real estate reported on Schedule A and all Other Invested Assets as reported on Schedule BA and DA.

(a) Calculation of the AVR:

The current year’s AVR by subcomponent is equal to:

The beginning balance  
plus (minus) the realized capital gains (losses) net of tax as allocated by the company on assets corresponding to the subcomponent  
plus (minus) unrealized capital gains (losses) on assets corresponding to the subcomponent  
plus (minus) transfers between components  
plus an annual contribution  
plus any voluntary contribution  
plus (minus) an adjustment up to zero or down to maximum.

(b) Realized Capital Gains and Losses:

Report all realized credit-related (default) and equity capital gains and (losses), net of capital gains tax applicable to the assets in each component and subcomponent including those realized capital gains and (losses) that are incurred on Separate Accounts assets for which AVR treatment is required. Exclude all interest rate related capital gains and (losses) from the AVR.

A realized gain or loss on a debt security will be a credit related gain or loss if the debt security’s beginning NAIC/SVO rating changed by more than one classification at the end of the holding period. The holding period is defined as the period from the date of purchase to the date of sale. For debt securities acquired before January 1, 1991 the debt securities rating as of December 31, 1990 should be the beginning rating used for this purpose. A debt security gain or loss should always be included in this reserve if the bond rating was ever a “6” during the holding period. Determination of the AVR gain or loss on multiple lots of the same fixed income securities should follow the underlying accounting treatment in determining gain or loss. Thus, the rating classifications, on a purchase lot basis, should be compared to the rating classification at the end of the holding period to determine IMR or AVR gain or loss. Permanent impairment write-downs are treated as credit-related (losses).

Preferred stock that had an NAIC/SVO rating classification of “PSF-4”, “PSF-5”, “PSF-6”, “P-4”, “P-5” or “P-6” at any time during the holding period shall be reported as credit related gains and (losses) in the Asset Valuation Reserve.
However, for a convertible bond or preferred stock purchased while its conversion value exceeds its par value, any gain or loss realized from its sale before conversion must be included in the Equity Component of the AVR. Conversion Value is defined to mean the number of share available currently or at next conversion date, multiplied by the stock’s current market price.

For preferred stocks acquired before January 1, 1993 the holding period is presumed to have begun on December 31, 1992.

In addition, all gains or losses, net of capital gains taxes, on mortgage loans, where interest is more than 90 days past due, in the process of foreclosure in course of voluntary conveyance, or have had restructured terms over the prior two years, would be classified as credit related gains or losses. Permanent impairment writedowns are also treated as credit losses.

Realized gains or losses net of capital gains tax on portfolio or general hedging instruments should be included with the hedged assets. Gains or losses net of capital gains tax on hedges used as specific hedges should be included only if the specific hedged asset is sold or disposed.

Realized gains or losses on derivative instruments not accounted for as specific (as opposed to general) hedge transactions should be allocated to the component and subcomponent of the assets associated with the derivative instruments used in the general hedge.

Realized gains or losses, net of capital gains resulting from the sale of U.S. Government Securities and the direct or guaranteed securities of agencies which are backed by the full faith and credit of the U.S. Government are exempt from the AVR. This category is detailed in Section 6(B)(g)(i).

The gains or (losses) are to be reported net of applicable capital gains taxes as allocated by the company.

(c) Unrealized Capital Gains and Losses:

Unrealized gains and losses should be summarized by subcomponent asset type and included in the reserve computation including those unrealized capital gains and (losses) that are incurred on Separate Account assets for which AVR treatment is required. The equity method of accounting is allowed in accounting for the operating results of subsidiary, controlled or affiliated companies. If the equity accounting method is used, the amount of the undistributed income or loss reported in Exhibit 2 of the Annual Statement less the amount of any dividends received is to be included as an unrealized capital gain or loss when computing the Common Stock Subcomponent. Unrealized gains and (losses) for Affiliated Life Insurance Companies which are maintaining their own AVR are excluded since the maximum reserve factor for such companies is 0%.

Unrealized gains or losses on hedging instruments should be included with the hedged instruments.

(d) Transfers Between Components:

If the sum of a subcomponent’s beginning balance, realized gains and losses and unrealized gains and losses is greater than the ending maximum of the subcomponent, and the balance of its sister subcomponent is below its maximum reserve, the excess must be transferred to the other subcomponent of the Default or Equity components up to that subcomponent’s maximum.

If after the above transfers, the Equity or Default component is greater than total maximum for the component, the excess may be transferred to the other component or may be released to surplus.
If the balance before transfers of any of the four sub-components is negative, and the balance before transfers of its "sister" subcomponent within the same component is positive, the negative amount should be transferred to the "sister" sub-component to the extent that the transfer does not reduce the positive balance before transfers of the "sister" sub-component to less than 50% of its balance prior to the transfer.

No other transfers may be made without Commissioner approval. No transfers between the AVR and IMR are allowed.

(e) Annual Contribution:

The formula for the annual contribution to a subcomponent is as follows:

The contribution rate times the difference between the subcomponent maximum amount and the accumulated balance. (Accumulated balance is shown on Page 49, Line 6 of the Annual Statement). This number will be positive when the maximum reserve exceeds the accumulated balance and negative when the accumulated balance is in excess of the maximum reserve.

(f) Contribution Rate:

The contribution rate is 20% per year.

(h) Voluntary Contribution to the Reserves:

Companies may make voluntary contributions to the subcomponents. Voluntary contributions will become a permanent part of the AVR once they have been reported and may not be removed in subsequent years.

39. The NAIC Annual Statement Instructions provide the following guidance (note that this is not quoted in its entirety):

**INTEREST MAINTENANCE RESERVE**

Interest Maintenance Reserve (IMR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an IMR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an IMR is not required for a separate account, none of the investments in that separate account are subject to the requirement.

An IMR is required for separate accounts valued at book but is not required for separate accounts valued at market. For example, separate accounts for traditional variable annuities, or variable life insurance do not require an IMR because assets and liabilities are valued at market.

If an IMR is required for investments in the Separate Accounts Statement, it is kept separate from the General Account IMR and accounted for in the Separate Accounts Statement.

**ASSET VALUATION RESERVE**

Asset Valuation Reserve (AVR) requirements for investments reported in the Separate Accounts Statement are applied on an account by account basis. If an AVR is required for a separate account, all of the investments in that separate account are subject to the requirement. If an AVR is not required for a separate account, none of the investments in that separate account are subject to the requirement (except to the extent that such investments represent the company’s capital and surplus interest in those investments).
Whether or not an AVR is required for separate account assets depends primarily on whether the insurer or policyholder/contractholder suffers the loss in the event of asset default or market value loss. An important exception to this is when specific state regulation provides an alternative to the AVR.

An AVR is required for separate account investments unless:

1. The asset default or market value risk is essentially borne directly by the policyholders, or
2. The regulatory authority for such separate accounts already explicitly provides for establishment of a reserve for asset default risk where such reserves are essentially equivalent to the AVR.

For example, assets supporting traditional variable annuities, and variable life insurance do not require an AVR because the policyholders/contractholders bear the risk of change in the value of assets. However, an AVR is required for that portion representing the company’s equity interest in the investments of such a separate account, (seed money interest, for example). Assets supporting typical modified guaranteed contracts or market value adjusted contracts do require an AVR because the company is responsible for credit related asset loss. Another category of contracts requiring an AVR is contracts with book value guarantees similar to contracts generally found in the general account.

An example of the exception referred to in (2) above are contracts with market value separate accounts funding guaranteed benefits where state regulation provides alternatives to the AVR.

The following criteria are presented to assist in determining when an AVR or an IMR are required for investments in the Separate Accounts Statement:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Does Co. Suffer Asset Loss?</th>
<th>If Yes, Any Other Provision?</th>
<th>AVR*</th>
<th>IMR</th>
<th>Example Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market</td>
<td>Market</td>
<td>No</td>
<td>--</td>
<td>No</td>
<td>No</td>
<td>Variable Annuity</td>
</tr>
<tr>
<td>Market</td>
<td>Market**</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Modified Gtd. Annuity</td>
</tr>
<tr>
<td>Market</td>
<td>Market</td>
<td>Yes</td>
<td>Yes</td>
<td>No***</td>
<td>No</td>
<td>MV S/A funding Gtd. Benefits</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>No</td>
<td>--</td>
<td>No</td>
<td>No</td>
<td>--</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>GIC in S/A</td>
</tr>
<tr>
<td>Book</td>
<td>Book</td>
<td>Yes</td>
<td>Yes</td>
<td>No***</td>
<td>Yes</td>
<td>--</td>
</tr>
</tbody>
</table>

* However, an AVR is required for that portion representing the company’s equity interest in the investments of such a separate account.

** But not less than adjusted cash surrender value.

*** You must establish an AVR reserve unless there is a statutory requirement for the equivalent of an AVR reserve for such products.
If an AVR is required for investments in the Separate Accounts Statement, it is combined with the General Account AVR and accounted for in the General Account Statement. Worksheets supporting the separate accounts portion of the reserve are included in the Separate Accounts Statement.

When the AVR Default Component covers assets valued at market, use one of the following two methods (applied consistently by separate account) to determine when a gain or loss (net of capital gains tax) is credited or charged to the AVR:

1. A gain or (loss) is recorded as for the general account rules, i.e., upon sale of an asset which has changed more than one rating category or upon asset default. Once an asset is in default, all subsequent market value changes are reflected in the AVR, or

2. A similar procedure to Method 1 above is followed but, additionally, a gain or (loss) is recorded whenever an asset held changes by more than one rating category. As there might be more than one such event for a particular asset, e.g., a two rating downgrade followed by subsequent sale of the asset, the amount charged the AVR is net of any prior amounts charged for that asset.

When an AVR is required for the company’s equity or capital and surplus interest in the investments of a particular separate account that does not otherwise require an AVR, the AVR requirement is based on the company’s equity interest as of the statement date, expressed as a percent of total assets of the particular separate account. Once the equity interest percentage has been determined, it is applied to the realized and unrealized capital gains and losses and the investments of that particular separate account to determine the amounts to be included in the separate accounts data used for development of the current AVR. If the company’s equity interest in all such separate accounts is less than 1/10th of 1% of the company’s total admitted assets, the equity interest in the investments of such separate accounts is exempt from AVR requirements.

40. Most state regulations refer to the literature of the NAIC for guidance on the calculation of AVR and IMR. An example is the Texas Administration Code, Title 28 - Insurance, Chapter 7, Corporate and Finance, which states:

(4) Asset valuation reserve (AVR) -- A reserve applied to the specific risk characteristics of all the invested asset categories except cash, policy loans, premium notes, collateral loans, and income receivables. Asset valuation reserves shall be calculated as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

(12) Interest maintenance reserve (IMR) -- A reserve applied to realized capital gains and losses on short-term and long-term fixed investments. These gains and losses are from the disposal of investments as reported in Schedule D, part 1 -- Bonds, or Schedule B -- Mortgage Loans of the current annual statement. The reserve captures the realized capital gains and losses resulting from changes in the general level of interest rates as prescribed by the NAIC and adopted from time to time by the State Board of Insurance under the Texas Administrative Code, Title 28, Chapter 7.

Generally Accepted Accounting Principles

41. FAS 60 provides the following guidance related to separate accounts:

Separate Accounts

53. Separate accounts represent assets and liabilities that are maintained by an insurance enterprise for purposes of funding fixed-benefit or variable annuity contracts, pension plans, and
similar activities. The contract holder generally assumes the investment risk, and the insurance enterprise receives a fee for investment management, certain administrative expenses, and mortality and expense risks assumed.

54. Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45-51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance enterprise.

The reporting requirements of FAS 60, paragraphs 45-51, have been amended by FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, FAS 97, FAS 114, FAS 115, and FAS 121.

42. AVR and IMR are not addressed in current GAAP literature.

43. Paragraph 28 of FAS 97, as amended by FAS 115, addresses the GAAP accounting for realized gains and losses. It states:

**Reporting of Realized Investment Gains and Losses of Investments**

28. Statement 60 required that insurance enterprises report realized gains and losses in the statement of earnings below operating earnings and net of applicable income taxes. This Statement precludes that practice. Realized gains and losses shall be reported in the statement of earnings as a component of other income, on a pretax basis, and shall not be deferred to future periods either directly or indirectly. The first sentence of paragraph 50 of Statement 60 is superseded by the following: Realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as hedges as described in FASB Statements No. 52, Foreign Currency Translation, and No. 80, Accounting for Futures Contracts) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred, either directly or indirectly.

**OTHER SOURCES OF INFORMATION**

44. The draft discussion material from previous Life Codification projects contains the following excerpts:

**Chapter 16A - Interest Maintenance Reserve**

All U.S. life insurance companies and fraternal benefit societies are required to establish an Interest Maintenance Reserve (IMR) for realized gains and losses resulting from changes in the overall level of interest rates on fixed income investments. The IMR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the IMR are periodically revised, the current publications should be consulted.

The purpose of the IMR is to protect surplus from investment transactions that are entered into as a reaction to interest rate movements. The IMR minimizes the effect that realized capital gains and losses attributable to interest rate movement have on current year operations by deferring and amortizing such capital gains and losses, net of tax, over the approximate remaining life of the investments sold. The IMR applies to realized capital gains and losses, net of tax, on short-term and long-term fixed income securities, including bonds, notes, preferred stock and
mortgages.

Chapter 16B - Asset Valuation Reserve

All U.S. life insurance companies and fraternal benefit societies must include as a liability in their statutory financial statement an Asset Valuation Reserve (AVR) on fixed income and equity investments. The AVR is calculated in accordance with instructions promulgated by the Valuation of Securities (EX4) Task Force of the National Association of Insurance Commissioners and contained in the Life, Accident and Health Annual Statement Instructions and the Valuation of Securities manual. Because the instructions for the calculation of the AVR are periodically revised, the current publications should be consulted.

The purpose of the AVR is to establish a provision for the volatile incidence of asset losses and recognize appropriately the long term return expectations for equity type investments. The AVR provides a mechanism to absorb unrealized and credit-related realized gains and losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable.

The AVR contains two components, default and equity, each designed to address specific asset risk areas. The default component is further divided into the bond and preferred stock subcomponent and the mortgage subcomponent; the equity component is comprised of the common stock subcomponent and the real estate and other invested asset subcomponent. Increases or decreases to the reserve are charged or credited directly to surplus. The AVR is limited to maximums by subcomponent, and no subcomponent of the AVR may be less than zero. Transfers between subcomponents or between components may be required or may be allowed without commissioner approval when negative or certain maximum subcomponent balances occur.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapters 10, 16 and 25
- NAIC Annual Statement Instructions
- Purposes and Procedures of the Securities Valuation Office of the NAIC, Section 6. Interest Maintenance Reserve and Asset Valuation Reserve for Life Insurance Companies and Fraternal Benefit Societies
- Minutes to the Separate Accounts Working Group Meeting of June 5, 1995
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 7 - Asset Valuation Reserve and Interest Maintenance Reserve
- Issue Paper No. 50 - Classifications and Definitions of Insurance or Managed Care Contracts In Force
- Issue Paper No. 51 - Life Contracts
- Issue Paper No. 52 - Deposit-Type Contracts

Generally Accepted Accounting Principles
- FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
- FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments
- FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
- FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*
- AICPA Statement of Position 95-1, *Accounting for Certain Activities of Mutual Life Insurance Enterprises*

**State Regulations**
- Texas Administration Code, Title 28 - Insurance, Chapter 7, *Corporate and Finance*

**Other Sources of Information**
- Draft discussion material from previous Life Codification projects, Chapter 16A, *Interest Maintenance Reserve*, and Chapter 16B, *Asset Valuation Reserve*
Statutory Issue Paper No. 90

Nonadmitted Assets

STATUS
FINALIZED MARCH 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. As described in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4), one of the cornerstones of statutory accounting is the use of nonadmitted assets. The use of nonadmitted assets is consistent with the recognition concept in the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. Current statutory accounting guidance for nonadmitted assets is provided throughout the Accounting Practices and Procedures Manuals for Life and Accident and Health Insurance Companies and Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices and Procedures Manuals).

3. The purpose of this issue paper is to establish statutory accounting principles for nonadmitted assets which are not specifically addressed in other issue papers, consistent with the Statement of Concepts and Issue Paper No. 4.

SUMMARY CONCLUSION

4. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of Issue Paper No. 4 as follows:

As stated in the Statement of Concepts, “The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which may be unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet”, and are, therefore, considered nonadmitted.

Issue Paper No. 4 defines nonadmitted assets as follows:

An asset meeting the criteria in paragraph 2 above which is accorded limited or no value in statutory reporting and is one which is:

a. Specifically identified within the Codification as a nonadmitted asset or

b. Not specifically identified within the Codification as an admitted asset.

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Codification. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires.
5. This paper shall not be considered an all-inclusive list of nonadmitted assets. Certain admitted assets and nonadmitted assets are addressed in other issue papers. Assets not addressed in specific issue papers are nonadmitted until specifically authorized.

6. Consistent with paragraph 4, the following assets shall be nonadmitted and shall be reported in accordance with Issue Paper No. 4.

**Deposits in Suspended Depositories**

7. Amounts on deposit with suspended depositories may not be fully recoverable. Any amounts not reasonably expected to be recovered shall be written off in accordance with Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5). Amounts in excess of that written off shall be nonadmitted as they are not available to satisfy obligations to policyholders.

**Bills Receivable Not for Premium and Loans Unsecured or Secured by Assets That Do Not Qualify As Investments**

8. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off are not considered to be properly collateralized as there are no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations.

**Loans on Personal Security, Cash Advances To, Or In The Hands Of, Officers Or Agents And Travel Advances**

9. In accordance with Issue Paper No. 5, amounts determined to be uncollectible or otherwise impaired shall be written off. Amounts in excess of that written off typically are unsecured and as such have no underlying assets which would otherwise be admitted assets. Such amounts shall be nonadmitted as they may be of questionable economic value if needed to fulfill policyholder obligations. Some of these items may also be considered prepaid expenses which, per Issue Paper No. 29 - Prepaid Expenses (excluding Deferred Policy Acquisition Costs and other underwriting expenses, income taxes, and Guaranty Fund Assessments), are nonadmitted.

**All “Non-Bankable” Checks**

10. Examples of “non-bankable” checks are NSF (non-sufficient funds) checks, post dated checks, or checks for which payment has been stopped. Although these checks may still maintain probable future benefits (and thus meet the definition of assets), at the date on which they are non-bankable they are not available for policyholder obligations and shall be nonadmitted until the uncertainty related to the probable future benefit is resolved and the checks are converted to available funds.

**Trade Names And Other Intangible Assets**

11. These assets, by their nature, are not readily marketable and available to satisfy policyholder obligations and shall be nonadmitted.

**Automobiles, Airplanes and Other Vehicles**

12. Automobiles, airplanes and other vehicles meet the definition of assets established in Issue Paper No. 4. However, they are not readily available to satisfy policyholder obligations and as a result the undepreciated portion shall be nonadmitted. The accounting for these assets shall be consistent with the accounting for equipment provided in Issue Paper No. 19 - Furniture, Fixtures and Equipment.
Company’s Stock as Collateral for Loan

13. When a reporting entity lends money and accepts its own stock as collateral for the loan, it shall report the amount of the loan receivable and any related accrued interest on the loan as a nonadmitted asset. The asset is nonadmitted as the collateral could not be used to satisfy the obligation in the event of default.

DISCUSSION

14. For those items specifically addressed within this issue paper the principles established are consistent with current statutory accounting practices except as follows:

a. With respect to the principles outlined in paragraphs 7, 8 and 9, current statutory accounting nonadmits a portion of or the entire amount of the asset. The conclusion above requires the write-off of the portion not expected to be recoverable in accordance with Issue Paper No. 5 with any remaining amounts being nonadmitted as outlined above.

b. In relation to paragraph 7, such treatment is consistent with current statutory accounting for life and accident and health insurance companies but is a change for property and casualty insurance companies as current statutory accounting requires only “the amounts on deposit in excess of what reasonably can be estimated as recoverable” to be nonadmitted.

c. Paragraphs 12 and 13 identify assets that are to be treated as nonadmitted assets. These assets are generally recognized as nonadmitted assets in current statutory accounting practice although they were not previously specifically stated as such.

15. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and Issue Paper No. 4.

Conservatism

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

Recognition

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

Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

16. Statutory treatment differs from GAAP in that GAAP does not have a concept of nonadmitted assets and would recognize the items addressed above as assets to the extent they remain collectible or recoverable.
Drafting Notes/Comments
- Issue Paper No. 5 discusses and outlines the appropriate treatment for the impairment of assets.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

17. The Life/A&H and P&C Accounting Practices and Procedures Manuals, page iv and page v, respectively, provide the following guidance:

ASSETS

paragraph 1

Because of the conservatism intrinsic to insurance accounting, certain assets may be accorded limited or no value in statutory reporting, i.e., nonadmitted assets.

18. Chapter 9, Nonadmitted Assets, of the P&C Accounting Practices and Procedures Manual provides guidance as outlined below. Many of the items given as examples in Chapter 9 have been addressed in separate issue papers and therefore are not addressed in the conclusion of this issue paper. Additionally, the accounting treatment for such items addressed in separate issue papers may no longer be consistent with the accounting treatment outlined in Chapter 9.

Because, in many respects, the statutory balance sheet is presented on a conservative basis, certain assets (which may have a recognized value in noninsurance corporations) are accorded no value and thus reduce the reported surplus of the insurance company. Some assets may be nonadmitted because they do not conform to the laws and regulations of the various states and other assets may be nonadmitted because they are not readily convertible to liquid assets. Changes in the amount of nonadmitted assets are charged or credited directly to surplus.

The following are examples of nonadmitted assets:

1. Excess of Book Value over Market Value of Securities: In keeping with the concept of presenting the balance sheet on a conservative basis, the unrealized loss on stocks and impaired bonds reduces the admitted asset value on the annual statement.

2. Deposits in Suspended Depositories (less the estimated recoverable amount): The amounts on deposit in excess of what reasonably can be estimated as recoverable are nonadmitted.

3. Agents’ Balances or Uncollected Premiums Over Three Months Due: The statutes of most states require that agents’ balances or uncollected premiums over three months due be nonadmitted because of the uncertainty of collection. The over three months rule does not apply to ceded reinsurance premiums payable due from solvent insurance companies provided the assuming insurer maintains sufficient reserves as to the ceding insurer to apply the principles of offset accounting or the ceding insurer is licensed and in good standing in the state of the assuming insurer’s domicile.

4. Future installments on all policies for which one or more installments are over three months due.

5. Accrued retrospective premiums from any person for whom any agents’ balances or uncollected premiums are classified as nonadmitted.
6. Bills Receivable, Taken for Premiums: Bills or notes receivable are used as methods of financing premiums usually in states where installment premiums are not permitted or customary. If any portion of a bill or note receivable is unpaid past the due date of the installment, the entire bill or note is classified as nonadmitted. Also, on bills or notes not past due, the excess of the balance due over the unearned premium on the underlying policy or policies is classified as a nonadmitted asset. To the extent bills receivable are taken for premium for retrospectively rated policies, such bills must meet the same criteria required of accrued retrospective premiums to be reported as an admitted asset.

7. Electronic Data Processing Equipment: Application systems software may be expensed when purchased or established as a nonadmitted asset and written off over a period of years not to exceed the software’s expected useful life.

8. Equipment, Furniture and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

9. Bills Receivable, Not Taken for Premiums: All bills or notes receivable - except those from an insured for premiums, or those fully secured by collateral- are classified as nonadmitted.

10. Loans on Personal Security: Loans on personal security by definition are not properly secured by collateral. Therefore, they are classified as nonadmitted.

11. Prepaid Expenses.

12. Cash Advances To, or In the Hands Of, Officers or Agents: These amounts are not secured by collateral and are, therefore, nonadmitted.

13. Travel Advances: Travel advances are nonadmitted since they are unsecured balances due from employees.

14. Surplus Notes: Insurers sometimes make subordinated surplus contributions to other insurers via an instrument variously referred to as “surplus notes”, “surplus debentures”, “contribution certificates”, “capital notes”, etc. Generally, these instruments allow for payment of interest and repayment of principal only with the approval of the commissioner of the domiciliary jurisdiction of the insurer receiving the surplus infusion and issuing the instrument. The form and content of such instruments are also subject to regulatory approval. Where such approval conditions exist, insurers should report these instruments as admitted assets only in an amount as determined by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners. The holders of such instruments should never be allowed an admitted asset value more than that which would be allowed by considering the instruments as equity instruments and adding same to any other equity investments in the issuer held directly or indirectly by the holder of the instruments. In addition, such instruments shall be considered in the limitations on investments in affiliates. Investment income on these instruments shall not be reported as accrued until payment by the issuer has been approved by the insurer’s domiciliary commissioner.

19. Chapter 9, Nonadmitted Assets, of the Life/A&H Accounting Practices and Procedures Manual provides the following guidance:

Some assets or portions thereof may be nonadmitted because they do not conform to the laws and regulations of the various states. As a result, certain assets which normally would be accorded value in noninsurance corporations are accorded no value and thus reduce the reported surplus of the insurance company. In addition, state regulations require that certain
expenditures which could normally be capitalized by a noninsurance company be charged as an expense.

Common Examples
Some examples of assets which are nonadmitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or other reasons are:

1. deposits in suspended depositories;
2. agents' debit balances;
3. bills receivable which are not properly secured by collateral;
4. loans on personal security (endorsed or not) which are not properly secured by collateral;
5. cash advance to or in the hands of officers or agents;
6. travel advances;
7. depreciated cost of applications software;
8. depreciated cost of equipment and furniture;
9. prepaid loss adjustment expenses;
10. other prepaid expenses;
11. all “NSF”, post dated, payment stopped or otherwise non-bankable checks;
12. group accident and health premiums more than 90 days past due;
13. individual accident and health premiums which are more than one modal premium past due;
14. the excess of premium notes over policy reserves on individual policies;
15. collateral loans secured by assets which do not qualify as investments.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, page iv and Chapter 9
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, page v and Chapter 9
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 19 - Furniture, Fixtures and Equipment
- Issue Paper No. 29 - Prepaid Expenses (excluding Deferred Policy Acquisition Costs and other underwriting expenses, income taxes, and Guaranty Fund Assessments)

Generally Accepted Accounting Principles
None

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 92

Statement of Cash Flow

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance on the Statement of Cash Flow is contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies and the Annual Statement Instructions for Property and Casualty Insurance Companies (Annual Statement Instructions).

2. GAAP guidance on the Statement of Cash Flow is primarily contained in FASB Statement No. 95, Statement of Cash Flows (FAS 95). Under GAAP, cash receipts and payments are classified according to whether they stem from operating, investing, or financing activities. FAS 95 also requires that investing and financing activities not resulting in cash receipts or payments in the period be disclosed separately.

3. The purpose of this issue paper is to establish statutory accounting principles for the Statement of Cash Flow that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. The Statement of Cash Flow shall be prepared using the direct method. Cash from operations shall be reported consistent with the Statement of Income, excluding the effect of current and prior year accruals. Only the cash portion of a transaction shall be reported in the Statement of Cash Flow. For purposes of the Statement of Cash Flow, cash shall include short term investments. Specific instructions for the classification of items are provided in the Annual Statement Instructions.

Disclosures
5. The financial statements shall disclose the following:

   a. Transactions considered to be investing and financing activities that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period (in narrative or schedule form);

   b. The cash and noncash aspects of the above transactions identified as investing or financing activities consistent with the classifications provided by the Annual Statement Instructions. Examples of noncash investing and financing transactions include:

      i. Converting debt to equity;
      ii. Acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller;
      iii. Exchanging noncash assets or liabilities for other noncash assets or liabilities.
DISCUSSION

6. This issue paper changes current statutory accounting to require that only cash transactions be included in the Statement of Cash Flow. The current Annual Statement Instructions are unclear and appear to indicate that any amount shown as consideration would be included in the statement.

7. Although the broad categories of cash receipts and disbursements are similar between GAAP and statutory accounting, there are differences in the individual items included in each category. The primary objective of the statutory statement is to enhance the ability to measure and monitor solvency of a reporting entity. The statutory statement is integrated into numerous other exhibits and schedules in the Annual Statement to facilitate preparation of the Statement of Cash Flow and to provide consistent reporting of information.

8. The focus of the GAAP Statement of Cash Flows is on a broad group of users of financial information. Those users include investors and creditors whose focus is assessing financial performance of the company. GAAP also provides for the use of two distinct methods of reporting cash flows known as the direct and indirect methods. Because GAAP is not consistent with the statutory objectives discussed above, FAS 95, FASB Statement No. 102, Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95, and FASB Statement No. 104, Statement of Cash Flows--Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95, are rejected in this issue paper.


10. Statutory guidance regarding disclosure about noncash investing and financing activities was added to provide users with complete disclosure of the investing and financing activities of a reporting entity.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Annual Statement Instructions for Property and Casualty Insurance Companies include the following guidance for the statement of cash flow. Similar language is provided in the Annual Statement Instructions for Life, Accident and Health Insurance Companies:

The statement of cash flows is prepared using the direct method. Lines one through nine should be prepared in a manner consistent with the Statement of Income, excluding the effect of current and prior year accruals. The following provides the method of preparing the statement. All revenue, expenditures, purchase and sales items should be entered gross.

The remaining portion of the guidance provided by the Annual Statement Instructions is a cross reference schedule which facilitates the preparation of the statement of cash flow by providing a series of calculations using various exhibits and schedules of a reporting entity’s Annual Statement.
Generally Accepted Accounting Principles

Introduction

1. This Statement establishes standards for providing a statement of cash flows in general-purpose financial statements. This Statement supersedes APB Opinion No. 19, Reporting Changes in Financial Position, and requires a business enterprise to provide a statement of cash flows in place of a statement of changes in financial position. It also requires that specified information about noncash investing and financing transactions and other events be provided separately.

2. Opinion 19 permitted but did not require enterprises to report cash flow information in the statement of changes in financial position. Since that Opinion was issued, the significance of information about an enterprise’s cash flows has increasingly been recognized. In FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, paragraph 13, the Board says, “A full set of financial statements for a period should show: . . . Cash flows during the period.” Moreover, certain problems have been identified in current practice, including the ambiguity of terms such as funds, lack of comparability arising from diversity in the focus of the statement (cash, cash and short-term investments, quick assets, or working capital) and the resulting differences in definitions of funds flows from operating activities (cash or working capital), differences in the format of the statement (sources and uses format or activity format), variations in classifications of specific items in an activity format, and the reporting of net changes in amounts of assets and liabilities rather than gross inflows and outflows. The lack of clear objectives for the statement of changes in financial position has been suggested as a major cause of that diversity.

Scope

3. A business enterprise or not-for-profit organization that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided. In this Statement enterprise encompasses both business enterprises and not-for-profit organizations, and the phrase investors, creditors, and others encompasses donors. The terms income statement and net income apply to a business enterprise; the terms statement of activities and change in net assets apply to a not-for-profit organization. A statement of cash flows is not required for defined benefit pension plans and certain other employee benefit plans or for certain investment companies as provided by FASB Statement No. 102, Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale.

Purpose of a Statement of Cash Flows

4. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

5. The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise’s ability to generate positive future net cash flows; (b) assess the enterprise’s ability to meet its obligations, its ability to pay dividends, and its needs for external
financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period.

6. To achieve its purpose of providing information to help investors, creditors, and others in making those assessments, a statement of cash flows should report the cash effects during a period of an enterprise's operations, its investing transactions, and its financing transactions. Related disclosures should report the effects of investing and financing transactions that affect an enterprise's financial position but do not directly affect cash flows during the period. A reconciliation of net income and net cash flow from operating activities, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also should be provided.

**Focus on Cash and Cash Equivalents**

7. A statement of cash flows shall explain the change during the period in cash and cash equivalents. The statement shall use descriptive terms such as cash or cash and cash equivalents rather than ambiguous terms such as funds. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

8. For purposes of this Statement, cash equivalents are short-term, highly liquid investments that are both:

   a. Readily convertible to known amounts of cash
   b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition.

9. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing, and financing activities, and details of those transactions need not be reported in a statement of cash flows.

10. Not all investments that qualify are required to be treated as cash equivalents. An enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 9 are treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

**Gross and Net Cash Flows**

11. Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 9, but also for certain other classes of cash flows specified in paragraphs 12, 13, and 28.
12. For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the enterprise is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the enterprise’s operating, investing, and financing activities.

13. Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to (a) investments (other than cash equivalents), (b) loans receivable, and (c) debt, providing that the original maturity of the asset or liability is three months or less.

Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

Classification of Cash Receipts and Cash Payments

14. A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.

Cash Flows from Investing Activities

15. Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise’s inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in Statement 102.

16. Cash inflows from investing activities are:
   a. Receipts from collections or sales of loans made by the enterprise and of other entities’ debt instruments (other than cash equivalents and certain debt instruments that are acquired specifically for resale) that were purchased by the enterprise
   b. Receipts from sales of equity instruments of other enterprises (other than certain equity instruments carried in a trading account) and from returns of investment in those instruments
   c. Receipts from sales of property, plant, and equipment and other productive assets.

17. Cash outflows for investing activities are:
   a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents and certain debt instruments that are acquired specifically for resale)
   b. Payments to acquire equity instruments of other enterprises (other than certain equity instruments carried in a trading account)
c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets.

Cash Flows from Financing Activities

18. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

19. Cash inflows from financing activities are:

   a. Proceeds from issuing equity instruments
   b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.
   c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment.

20. Cash outflows for financing activities are:

   a. Payments of dividends or other distributions to owners, including outlays to reacquire the enterprise’s equity instruments
   b. Repayments of amounts borrowed
   c. Other principal payments to creditors who have extended long-term credit.

Cash Flows from Operating Activities

21. Operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15-20. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

22. Cash inflows from operating activities are:

   a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.
   b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities--interest and dividends
   c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

23. Cash outflows for operating activities are:

   a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.
b. Cash payments to other suppliers and employees for other goods or services  
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties  
d. Cash payments to lenders and other creditors for interest  
e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

24. Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

Foreign Currency Cash Flows

25. A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

Content and Form of the Statement of Cash Flows

26. A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents.

27. In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:

a. Cash collected from customers, including lessees, licensees, and the like  
b. Interest and dividends received. Interest and dividends that are donor restricted for long-term purposes as noted in paragraphs 18 and 19(c) are not part of operating cash receipts.  
c. Other operating cash receipts, if any  
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like  
e. Interest paid  
f. Income taxes paid  
g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.
28. Enterprises that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 27 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to remove (a) the effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables, and (b) the effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, and gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

29. The reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities described in paragraph 28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. That reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including at a minimum changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities, shall be separately reported. Enterprises are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an enterprise's sale of goods or services might be reported separately from changes in other operating receivables. In addition, if the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period shall be provided in related disclosures.

30. If the direct method of reporting net cash flow from operating activities is used, the reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities. If the reconciliation is presented in the statement of cash flows, all adjustments to net income of a business enterprise or change in net assets of a not-for-profit organization to determine net cash flow from operating activities shall be clearly identified as reconciling items.

31. Except for items described in paragraphs 12 and 13, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows—for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the enterprise's stock.

Information about Noncash Investing and Financing Activities

32. Information about all investing and financing activities of an enterprise during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be reported in related disclosures. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities. Some transactions are part
cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

**Cash Flow per Share**

33. Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise’s performance, as reporting per share amounts might imply.


**ISSUE**

Debt issue costs generally are incurred in connection with the issuance of debt securities or other short- or long-term borrowings. Opinion 21 requires that debt issue costs be reported in the balance sheet as deferred charges. Generally, debt issue costs are capitalized as an asset and amortized over the term of the debt.

Statement 95 requires that cash receipts and payments in a statement of cash flows be classified as operating, investing, or financing activities. However, some believe that Statement 95 does not provide specific guidance on the classification of debt issue costs in the statement of cash flows. Because debt issue costs have aspects of more than one class of cash flows, diversity in practice has arisen. Some companies have reported the cash outflow for debt issue costs as a financing activity, while others have reported the outflow for those costs as an operating activity.

The issue is how cash payments for debt issue costs should be classified in the statement of cash flows.

**EITF DISCUSSION**

The Task Force reached a consensus that cash payments for debt issue costs should be classified in the statement of cash flows as a financing activity.

**RELEVANT LITERATURE**

**Statutory Accounting**

- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life, Accident and Health Insurance Companies

**Generally Accepted Accounting Principles**

- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 102, *Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95*

**State Regulations**

- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 94

Allocation of Expenses

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Expenses involved in acquiring and underwriting policies and servicing policyholders and third-party claimants are important elements of a reporting entity’s operations. Uniformity in the classification, allocation and reporting of expenses and expense statistics by reporting entities within the same industry is critical in a regulatory environment and is consistent with both the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts) and the FASB Statements of Financial Accounting Concepts (GAAP Statement of Concepts). Such uniformity is necessary for the effective review of operations of a specific entity, comparisons across the industry and control/regulation of the industry.


3. This issue paper establishes rules on presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of companies. The scope of this issue paper is limited to the general categories. Disclosure in notes or exhibits to the financial statements is required for principal components of those categories.

SUMMARY CONCLUSION

4. This paper establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this issue paper will refer to as allocable expenses.

5. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

- Loss adjustment expenses - Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations).

- Investment expenses - Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds.

- Other underwriting expenses - Allocable expenses other than loss expenses and investment
related expenses.

6. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

7. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

8. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

9. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group. Pertinent factors in making this determination shall include which entity has the ultimate obligation to pay the expense. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 5 through 8.

10. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related exhibits to the financial statements.

DISCUSSION

11. The summary conclusions outlined above were formulated based upon, and are consistent with, current statutory accounting practices and procedures as set out in the P&C and Life/A&H Accounting Practices and Procedures Manuals, the Annual Statement Instructions and additional guidance contained in the Financial Condition Examiners Handbook. The conclusions are also consistent with the Statutory Statements of Concepts which states the following:

SAP utilizes the framework established by GAAP.

Consistency

The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles.

The conclusions are also consistent with the GAAP Statements of Concepts which are excerpted in paragraphs 16 and 17.
12. The exhibits to the annual statement display the effects of allocation of allocable expenses to the various categories as well as provide an appropriate level of detail as to the nature of the classifications of expenses being allocated. The disclosure required by Paragraph 10 provides disclosure as to the nature of the significant allocable expenses in those circumstances where the accompanying exhibits are not part of the company’s financial statements (e.g. annual audit report) and is not intended to provide duplicative presentation in the annual statement filings.

Drafting Notes/Comments
- Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses, defines and discusses losses and loss adjustment expenses.
- Detailed classification tables, which are included in current statutory guidance for property and casualty companies, are not included in this issue paper. Such guidance is not considered necessary for the establishment of accounting standards/policies.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
13. The P&C Accounting Practices and Procedures Manual, Chapter 19, Expenses, provides the following guidance:

In the insurance industry, there are expenses involved in acquiring and underwriting policies and servicing the policyholders and third party claimants. These expenses will be discussed in this chapter. (Commissions are discussed in Chapter 18.)

Regulation Number 30, called the "Uniform Classification of Expenses of Fire and Marine and Casualty and Surety Insurer," was effective January 1, 1949, for licensed New York companies. The NAIC prescribed similar uniform accounting instructions for expense reporting effective January 1, 1949. These acts brought uniformity to the industry.

This uniformity is helpful since expenses are important elements of the company’s operations and accurate statistics are needed for comparisons and control. The instructions for uniform classification of expenses are a part of the NAIC Examiners Handbook—Volume I.

Expense Group Classifications

Expenses for fire and casualty insurance companies are allocated to expense groups as follows:

A. Loss Adjustment Expenses

Loss adjustment expenses constitute expenses incurred in connection with the adjusting, recording, and paying of claims. (See Chapter 17-Loss and Loss Adjustment Expenses Incurred.)

B. Other Underwriting Expenses

Other underwriting expenses are classified into three categories as follows:
1. Acquisition, Field Supervision, and Collection Expenses

Acquisition costs consist of all expenses incurred in relation to the production of new and renewal insurance business. Also included are specifically identifiable and allocated expenses relating to the following activities: commissions, bonuses, allowances, and other compensation paid to agents and brokers; operating costs for agencies or branch offices; training agents and brokers; underwriting new risks; issuing new policies; receiving and paying of premiums and commissions; maintaining general and detailed records; data processing; advertising and publicity; clerical, secretarial, office maintenance, supervisory, and executive duties; postage and supplies; and all other functions reasonably associated with the production of new and renewal insurance business, such as premium collection.

2. General Expenses

This category includes all expenses not assignable to other expense groups.

3. Taxes, Licenses, and Fees

These are state and local insurance taxes, insurance department licenses and fees, allocable payroll taxes, and all other taxes excluding federal and foreign income and real estate taxes.

All other taxes might include: (1) qualifying bond premiums; (2) statement publication fees; (3) advertising required by law; (4) personal property taxes; (5) state income taxes; (6) capital stock taxes; (7) business or corporation licenses or fees; (8) marine profits taxes; (9) documentary stamps on reinsurance; (10) guaranty association assessments; and (11) any other taxes.

Real estate taxes on investment properties are generally included with investment expenses, and capital stock taxes and apportioned payroll taxes may be reported as investment expenses.

C. Investment Expenses

These comprise expenses incurred in the investing of funds and the pursuit of investment income, including specifically identifiable and allocated expenses related to such activities as: initiating or handling orders and recommendations for investments; research; pricing; appraising and valuing; disbursing funds and collecting income; safekeeping of securities and valuable papers; maintaining general and detailed records; data processing; general clerical, secretarial, office maintenance, supervisory, and executive duties; supplies, postage, and the like; and all other functions reasonably attributable to the investment of funds.

Allocation of Expenses to Expense Groups

Some general guidelines for allocating to expense groups are shown in the following table. The expenses shown are those in the annual statement.
TABLE 19

General Guidelines for Classifying Expenses

<table>
<thead>
<tr>
<th>Expenses to be Allocated to Expense Groups</th>
<th>Principal Basis for Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim adjustment services</td>
<td>Direct charge to loss adjustment expense</td>
</tr>
<tr>
<td>Commission and brokerage</td>
<td>Direct charge to other underwriting acquisition</td>
</tr>
<tr>
<td>Advertising</td>
<td>Direct charge to other underwriting acquisition</td>
</tr>
<tr>
<td>Boards, bureaus, associations</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Surveys and underwriting reports</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Audit of insureds’ records</td>
<td>Direct charge to other underwriting - general</td>
</tr>
<tr>
<td>Salaries</td>
<td>Studies of employee activities</td>
</tr>
<tr>
<td>Employee relations and welfare</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Insurance</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Directors’ fees</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Travel and travel items</td>
<td>Special studies</td>
</tr>
<tr>
<td>Rent and rent items</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Equipment</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Printing and stationery</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Postage, telephone and telegraph, exchange and express</td>
<td>Pro rate on salary ratios</td>
</tr>
<tr>
<td>Legal and auditing</td>
<td>Special studies</td>
</tr>
<tr>
<td>Taxes, licenses, and fees (Except payroll taxes)</td>
<td>Special studies</td>
</tr>
<tr>
<td>Real estate expenses</td>
<td>Investment expenses</td>
</tr>
<tr>
<td>Real estate taxes</td>
<td>Investment expenses</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special studies</td>
</tr>
</tbody>
</table>

Any other basis of allocation which yields a more accurate result may be used for those expenses being allocated on the basis of salaries. Any basis of allocation which is found to be inappropriate should be discounted.

Apportionment of Joint Expenses

Many insurance companies operate on a group basis, sharing personnel and facilities in conducting
business. When this occurs, the expenses involved must be properly apportioned to the company incurring the expenses, and included in the same expense classifications as if originally paid by that company.

Some examples of specifically identifiable expenses that may be incurred solely on behalf of one company, and charged directly to the applicable company are:

1. Advertising;
2. Claims adjustment services;
3. Commissions and brokerages;
4. Taxes and real estate expenses;
5. Employees’ salaries;
6. Any other expenses that can be attributed directly in whole or in part to a specific company.

The following table contains some general guidelines for apportioning joint expenses among companies.

**TABLE 19-B**

<table>
<thead>
<tr>
<th>Expense Item</th>
<th>Basis for Apportionment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>Percentage of premiums</td>
</tr>
<tr>
<td>Boards, bureaus, associations</td>
<td>Special studies</td>
</tr>
<tr>
<td>Surveys and underwriting reports</td>
<td>Special studies</td>
</tr>
<tr>
<td>Audit of insureds’ records</td>
<td>Special studies</td>
</tr>
<tr>
<td>Salaries</td>
<td>Studies of employee activities</td>
</tr>
<tr>
<td>Employee relations and welfare</td>
<td>Salaries</td>
</tr>
<tr>
<td>Insurance</td>
<td>Salaries</td>
</tr>
<tr>
<td>Travel and travel items</td>
<td>Special studies</td>
</tr>
<tr>
<td>Rent and rent items</td>
<td>Salaries</td>
</tr>
<tr>
<td>Equipment</td>
<td>Salaries</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Salaries</td>
</tr>
<tr>
<td>Postage, telephone and telegraph, exchange and express</td>
<td>Salaries</td>
</tr>
<tr>
<td>Legal and auditing</td>
<td>Special studies</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>Salaries</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special studies</td>
</tr>
</tbody>
</table>
Any other basis of allocation should be used if it yields more precise results than expenses allocated on the salaries or premium basis. If clearly inappropriate, allocation based on salaries or premium should not be employed.

A company that pays joint expenses, which are ultimately apportioned and charged to other companies in the group, should credit the apportioned expenses to the same expense items charged when the payment was made. Apportionment expenses generally should not be reported as income nor be accumulated in a separate account used to reduce total expenses for the company.

14. The Life/A&H Accounting Practices and Procedures Manual, Chapter 22, General Expenses and Taxes, Licenses and Fees, provides the following guidance:

General expenses include virtually all of the expenses of a life insurance company other than benefits to policyholders, commissions, and taxes, licenses and fees.

The statutory financial statement provides for two broad categories of general expenses: (1) insurance, which is further subdivided into life insurance, accident and health insurance, and all other lines of business and (2) investment. In addition, general expenses are allocated to more detailed lines of business in the Analysis of Operations by Lines of Business. In the Summary of Operations, the investment expense portion of general expenses is classified as an offset to investment income while general insurance expenses are reported separately in the expense section of the summary.

15. The Annual Statement Instructions for Property and Casualty Companies - Underwriting and Investment Exhibit - Part 4 - Expenses provides the following guidance:

A company that pays any affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification items (salaries, rent, postage, etc.) as if these costs had been borne directly by the company. Management, administration, or similar fees should not be reported as a one-line expense. The company may estimate these expense allocations based on a formula or other reasonable basis.

A company that pays any non-affiliated entity (including a managing general agent) for the management, administration, or service of all or part of its business or operations shall allocate these costs to the appropriate expense classification item as follows:

a) Payments for claims handling or adjustment services shall be allocated to “Loss Adjustment Expenses” (Column 1) in the Underwriting and Investment Exhibit–Part 4. If the total of such expenses incurred equals or exceeds 10% of the total incurred “Loss Adjustment Expenses” (Column 1, Line 22), the company shall allocate these costs to the appropriate expense classification items as if these costs had been borne directly by the company. If such expenses are less than 10% of the total, they may be reported on Line 1 of Column 1.

b) Payments for services other than claims handling or adjustment services shall be allocated to the appropriate expense classification items as if these costs had been borne directly by the company, if the total of such fees paid equals or exceeds 10% of the total incurred “Other Underwriting Expenses” (Column 2, Line 22). If the total is less then 10%, the payments may be reported on Line 2 if the fees are calculated as a percentage of premium, or on Line 3 if the fees are not calculated as a percentage of premium.

The total management and service fees paid to affiliates and non-affiliates shall be reported in the footnote to the Underwriting and Investment Exhibit–Part 4 of the annual statement, and the method(s) used for allocation shall be disclosed in the Notes to the Financial Statements. The company shall use the same allocation method(s) on a consistent basis.
The Annual Statement Instructions for Life and Accident and Health Companies contains similar guidance.

**Generally Accepted Accounting Principles**

16. FASB Statement of Financial Accounting Concepts No. 2, *Summary of Principal Conclusions*, provides the following guidance:

**Comparability and Consistency**

Information about a particular enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

17. FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, provides the following guidance:

paragraph 20

Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

**OTHER SOURCES OF INFORMATION**

18. The Financial Condition Examiners Handbook - Volume 1, Chapter 6 provides the following guidance:

22. **GENERAL INSTRUCTIONS IN CONNECTION WITH OPERATING EXPENSE CLASSIFICATIONS**

   A. **Joint Expenses**

   Whenever personnel or facilities are used in common by two or more companies, or whenever the personnel or facilities of one company are used in the activities of two or more companies, the expenses involved shall be apportioned in accordance with the regulations relating to Joint Expenses, and such apportioned expenses shall be allocated by each company to the same operating expense classifications as if the expenses had been borne wholly. Any difference between the actual amount paid, and the amount of such apportioned expenses shall be included in the operating expense classification "Miscellaneous."
PART II
RULES RELATING TO THE ALLOCATION OF JOINT EXPENSES TO COMPANIES

1. JOINT EXPENSES

A. Joint Expenses, as described in Part 1, Sec. 22 (A), shall be allocated to companies as follows:

<table>
<thead>
<tr>
<th>Expenses To Be Allocated To Companies (as amended)</th>
<th>Bases of Allocation to Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td>Premiums</td>
</tr>
<tr>
<td>Boards, Bureaus, and Associations</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Surveys and Underwriting Reports</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Audit of Assureds' Records</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Salaries</td>
<td>See Special Instructions Relating to the Allocation of Salaries and Other Expenses (Part V)</td>
</tr>
<tr>
<td>Employee Relations and Welfare</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Insurance</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Travel and Travel Items</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Rent and Rent Items</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Equipment</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Postage, Telephone and Telegraph, Exchange and Express</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Legal and Auditing</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Payroll Taxes</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Special Studies</td>
</tr>
</tbody>
</table>

B. Definitions

The term Premiums used as a basis of allocation means that the allocation of expenses shall follow the percentages of applicable premiums.

The term Special Studies used as a basis of allocation means that expenses shall be analyzed and bases of allocation applied as dictated by that analysis.

The term Overhead on Salaries used as a basis of allocation means that the allocation of expenses shall follow the percentages of the applicable salaries allocation.

C. Other Bases Permitted or Prescribed

For those operating expense classifications permitting the basis, Overhead on Salaries or Premiums, any other basis of allocation may be adopted which yields more accurate results. The bases Overhead on Salaries and Premiums shall not be used if clearly in appropriate.

PART III
RULES RELATING TO THE COMPOSITION OF, AND ALLOCATION TO, EXPENSE GROUPS

(as amended 1953 Proc. II 643-644)
1. LIST OF EXPENSE GROUPS

Expense reported in the operating expense classifications shall be allocated to the following expense groups:

- Investment Expenses
- Loss Adjustment Expenses
- Acquisition, Field Supervision and Collection Expenses
- Taxes
- General Expenses

2. COMPOSITION OF THE EXPENSE GROUPS (as amended)

The composition of each group shall be as follows:

A. Investment Expenses

Investment Expenses shall comprise all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income, including related expenses incurred in the following activities: initiating or handling orders and recommendations; doing research; pricing; appraising and valuing; paying and receiving; entering and keeping general and detail records, safe keeping; collecting, recording, calculating and accruing investment income; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, mail, etc.; and all other activities reasonably attributable to the investing of funds and the obtaining of investment income.

B. Loss Adjustment Expenses

Loss Adjustment Expenses shall comprise all expenses incurred wholly or partially in connection with the adjustment and recording of policy claims, including the totals of the operating expense classification, Claim Adjustment Services; the types of expenses included in Claim Adjustment Services, when the activities resulting in such types of expenses are performed by employees; and including related expenses incurred in the following activities: estimating amounts of claims; paying and receiving; entering and keeping general and detail records; general clerical, secretarial, office maintenance, supervisory and executive duties; handling personnel, supplies, mail, etc.; and all other activities reasonably attributable to the adjustment and recording of policy claims in connection with claims reported, paid and outstanding, and reinsurance thereon.

C. Acquisition, Field Supervision, and Collection Expenses

(1) Acquisition, Field Supervision and Collection Expenses shall comprise all expenses incurred wholly or partially in the following activities:

a. Soliciting and procuring business and developing the sales field;

b. Writing policy contracts, and checking and directly supervising the work of policy writers;

c. Receiving and paying of premiums and commissions; entering into or setting up records of premiums and commissions receivable and payable for collection purposes; balancing and maintaining such records; corresponding with and visiting insureds and producers for the purpose of collecting premiums or adjusting differences; checking current accounts from producers; auditing of records of delinquent agents; and services of collection agencies; (Do not include activities in connection with accounts receivable from and payable to branch or other officers within the company.)

d. Compiling and distributing expiration lists, notices of premiums due, lists of premiums or premium balances receivable and payable, contingent and other commission statements, production statements for acquisition and field supervision purposes, and similar data;
e. Maintaining good will of insureds and producers; activities of field men; contact work related to acquisition, field supervision and collection; making contracts and agreements with producers; and activities in connection with agency appointments and replacements; (Do not include: inspections of risks when carried on by personnel employed by the insurance company, engaged full time in physical inspection of risks and activities directly related thereto; audits for the purpose of premium determination; and activities in connection with the adjustment of policy claims.)

f. Rendering service to agents and other producers, such as providing office space, personnel, telephone, etc. and obtaining agents’ licenses; (Do not include fees paid for agents’ licenses.)

g. Advertising and publicity of every nature related to acquisition, field supervision and collection; (In addition to applicable salaries, etc., include the entire amount shown in the operating expense classification, Advertising.)

h. Miscellaneous activities of agents, brokers and producers other than employees, when performed by them: inspections; quoting premiums; signing policies; examining and mailing policies, applications and daily reports; compiling figures for current account; correspondence and sundry bookkeeping and clerical work;

i. Other activities reasonably attributable to those operations listed in “a” to “h,” such as: keeping general and detail records; paying and receiving, general clerical, secretarial, office maintenance, supervisory and executive work; and handling personnel, supplies, mail, etc.

(2) Commission and Allowances: When the whole or a part of any amount in the operating expense classifications Commission and Brokerage—Direct, and Allowances to Managers and Agents is paid specifically for services other than those set forth under “a” to “i,” and when such services are not duplicated or otherwise compensated by the company, the amount thereof shall be allocated to expense groups other than Acquisition, Field Supervision and Collection, and such allocations shall be justified by detailed statements and data calculated and prepared in accordance with the methods prescribed in these Rules showing amounts of expenditures, property allocated to expense groups and lines of business.

When Allowances to Managers and Agents represent a division of expenses shared with other companies, the aforementioned statements and data shall show the division of such shared expenses calculated and prepared in accordance with the methods prescribed in these Rules.

The calculation and preparation of the aforementioned statements and data shall be subject to verification and audit by insurance department personnel.

The instructions under the heading Commission and Allowances to not apply to Commission and Brokerage—Reinsurance Assumed, or Commission and Brokerage—Reinsurance Ceded.

D. Taxes

Taxes shall comprise the totals of the operating expense classification Taxes, Licenses and Fees.

E. General Expenses

General Expenses shall comprise all expenses not assignable by these rules to other expense groups.
3. **ALLOCATION TO EXPENSE GROUPS (as amended)**

A. Expenses shall be allocated to expense groups as follows:

<table>
<thead>
<tr>
<th>Expenses To Be Allocated</th>
<th>Allocation to Expense Groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim Adjustment Services:</td>
<td></td>
</tr>
<tr>
<td>Direct</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Reinsurance Assumed</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Reinsurance Ceded</td>
<td>Loss Adjustment Expenses</td>
</tr>
<tr>
<td>Commission and Brokerage:</td>
<td></td>
</tr>
<tr>
<td>Direct</td>
<td>See Commission and Allowances</td>
</tr>
<tr>
<td></td>
<td>(Part III, Sec. 2 (C)(2))</td>
</tr>
<tr>
<td>Reinsurance Assumed</td>
<td>Acquisition, Field Supervision and</td>
</tr>
<tr>
<td></td>
<td>Collection Expenses</td>
</tr>
<tr>
<td>Reinsurance Ceded</td>
<td>Acquisition, Field Supervision and</td>
</tr>
<tr>
<td></td>
<td>Collection Expenses</td>
</tr>
<tr>
<td>Contingent—Net</td>
<td>Acquisition, Field Supervision and</td>
</tr>
<tr>
<td></td>
<td>Collection Expenses</td>
</tr>
<tr>
<td>Policy and Membership Fees</td>
<td>Acquisition, Field Supervision and</td>
</tr>
<tr>
<td></td>
<td>Collection Expenses</td>
</tr>
<tr>
<td>Allowances to Managers and Agents</td>
<td>See Commission and Allowances</td>
</tr>
<tr>
<td></td>
<td>(Part III, Sec. 2 (C)(2))</td>
</tr>
<tr>
<td>Advertising</td>
<td>Acquisition, Field Supervision and</td>
</tr>
<tr>
<td></td>
<td>Collection Expenses</td>
</tr>
<tr>
<td>Boards, Bureaus and Associations</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Surveys and Underwriting</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Reports</td>
<td>General Expenses</td>
</tr>
<tr>
<td>Audit of Assureds’ Records</td>
<td>See Special Instructions Relating</td>
</tr>
<tr>
<td></td>
<td>to the Allocation of Salaries and</td>
</tr>
<tr>
<td></td>
<td>Other Expenses (Part V)</td>
</tr>
<tr>
<td>Salaries</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td></td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td></td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Employee Relations and Welfare</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Insurance</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Directors’ Fees</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Travel and Travel Items</td>
<td>Special Studies</td>
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<td>Rent and Rent Items</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Equipment</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Printing and Stationery</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Postage, Telephone and Telegraph, Exchange and Express</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Legal and Auditing</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Taxes, Licenses and Fees</td>
<td>Special Studies</td>
</tr>
<tr>
<td>Real Estate Expenses</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Income from Special Services</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td></td>
<td>Overhead on Salaries</td>
</tr>
<tr>
<td></td>
<td>Special Studies</td>
</tr>
<tr>
<td></td>
<td>Special Studies</td>
</tr>
</tbody>
</table>

B. **Definitions**

For definitions of the term Overhead on Salaries and Special Studies, see Part II, Sec. 1 (B).

C. **Other Bases Permitted or Prescribed**

For those operating expense classifications permitting the basis Overhead on Salaries, any other basis of allocation may be adopted which yields more accurate results. The basis Overhead on Salaries shall not be used if clearly inappropriate.
RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 19
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 22
- Annual Statement Instructions for Property and Casualty Companies and for Life and Accident and Health Companies

Generally Accepted Accounting Principles
- FASB Statement of Financial Accounting Concepts No. 2, Summary of Principal Conclusions

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Financial Condition Examiners Handbook - Volume 1, Chapter 6
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Statutory Issue Paper No. 95

Holding Company Obligations

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Statutory accounting currently requires disclosure of holding company obligations which are guaranteed. It does not specifically address a reporting entity subsidiaries’ accounting treatment of obligations of a holding company parent when the subsidiary does not guarantee the obligation, however, it is accepted statutory practice that these obligations are not recorded or disclosed.

2. The Financial Accounting Standards Board (FASB) has been unable to reach a consensus that any particular method of presentation is preferable related to this issue. The SEC staff believes that when debt is incurred in connection with or otherwise related to the acquisition of a subsidiary in a purchase transaction and a subsidiary subsequently files a registration statement in connection with a public offering of its stock or debt, the parent company’s debt, related interest expense, and allocable debt issue costs should be reflected in the subsidiary’s financial statements included in the public offering if (1) the subsidiary is to assume the debt of the parent, either presently or in a planned transaction in the future, (2) the proceeds of a debt or equity offering of the subsidiary will be used to retire all or a part of the parent company’s debt, or (3) the subsidiary guarantees or pledges its assets as collateral for the parent company’s debt.

3. The purpose of this issue paper is to establish statutory accounting principles for recording and disclosure requirements of holding company obligations and any related guarantees in the financial statements of a subsidiary that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. In situations where the reporting entity does not guarantee the obligation of the holding company, there is no legal obligation on the part of the reporting entity. Therefore, the reporting entity shall not record the obligation of its parent holding company unless the obligation relates to services or benefits incurred by a non-insurance parent company or holding company on its behalf. In these situations, the reporting entity shall recognize an expense for its share of the services or benefits incurred on its behalf during the period by the parent company or holding company based on an allocation from the parent or holding company. A liability shall be established for any such amounts due, but not yet paid. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. Issue Paper No. 8 - Accounting for Pensions (Issue Paper No. 8), Issue Paper No. 11 - Compensated Absences (Issue Paper No. 11), Issue Paper No. 13 - Employers’ Accounting for Postemployment Benefits (Issue Paper No. 13), and Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions (Issue Paper No. 14) address specific examples where the obligation relates to benefits provided to the subsidiary by a non-insurance parent company or holding company.

5. If the reporting entity guarantees an obligation of the holding company, the guidance in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) shall be followed for determining the recording and disclosure of the guarantee. Issue Paper Nos. 8, 11,
13 and 14 provide specific accounting and disclosure guidelines for employee benefit plans when the reporting entity is directly liable for obligations under the plan.

**DISCUSSION**

6. Statutory accounting requires that a reporting entity record only its direct assets and direct obligations and not those of related parties. If the reporting entity has no legal obligation related to the holding company’s obligations, the entity shall not record those obligations unless there is a guarantee of such debt that would require recording under the guidance in Issue Paper No. 5 or unless the obligation falls under the requirements discussed in paragraph 4. This is supported by the recognition concept included in the Statement of Concepts.

7. This issue paper rejects the requirements of SEC Staff Accounting Bulletin No. 73, *Push-Down Basis of Accounting Required in Certain Limited Circumstances* (SAB 73). The subsidiary has no direct legal obligation and, therefore, SAB 73 is inconsistent with statutory accounting principles as described in the Statement of Concepts. Other than the instances described in paragraph 4, the only way funding can be provided by the reporting entity to the holding company is through the payment of dividends and these payments are restricted to the amounts approved by the state insurance departments for the purpose of providing protection of surplus. As a result, the holding company can not legally require the reporting entity to fund debt payments in excess of the allowable dividends.

**Drafting Notes/Comments**
None

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

8. As discussed above, there is no current statutory guidance specifically related to this issue. The following disclosure requirements are outlined in the NAIC Annual Statement Instructions for Property and Casualty Companies - Notes to Financial Statements:

5. **Information Concerning Parent, Subsidiaries and Affiliates**
   e. Describe guarantees or undertakings for the benefit of an affiliate which result in a material contingent exposure of the company’s or any affiliated insurer’s assets to liability, if not disclosed. Report the total amount of guarantees for affiliates.

9. **Contingent Liabilities**
   a. Report briefly the nature of any material contingent liabilities including but not limited to: notes receivable discounted, reverse repurchase agreements, accounts and agents’ balances assigned, accommodation paper, additional taxes, guarantees of liabilities of other companies (including companies that act as dealers in Over the Counter derivative instruments or as a Futures Commissions Merchant establishing of compensating balances, long-term contracts, loan take-out agreements and indemnification agreements, deferred expense contracts, structured settlements and arrangements between parents, subsidiaries or affiliates. Include in the disclosure: The date incurred or discovered; the nature of the contingent liability, contract, agreement or commitment; the amount or amounts, if known; the status as of the annual statement date; and all other information necessary for a full disclosure. Report the total amount of contingent liabilities.

The Annual Statement Instructions for Life and Accident and Health Companies contain similar requirements.
OTHER SOURCES OF INFORMATION

9. SAB 73 provides the following guidance:

Facts:
Company A (or Company A and related persons) acquired substantially all of the common stock of Company B in one or a series of purchase transactions.

Question 1:
Must Company B’s financial statements presented in either its own or Company A’s subsequent filings with the Commission reflect the new basis of accounting arising from Company A’s acquisition of Company B when Company B’s separate corporate entity is retained?

Interpretative Response:
Yes. The staff believes that purchase transactions that result in an entity becoming substantially wholly owned (as defined in Rule 1-02 (z) of Regulation S-X) establish a new basis of accounting for the purchased assets and liabilities.

When the form of ownership is within the control of the parent the basis of accounting for purchased assets and liabilities should be the same regardless of whether the entity continues to exist or is merged into the parent’s operations. Therefore, Company A’s cost of acquiring Company B should be “pushed down”, i.e., used to establish a new accounting basis in Company B’s separate financial statements.

Question 2:
What is the staff’s position if Company A acquired less than substantially all of the common stock of Company B or Company B had publicly held debt or preferred stock at the time Company B became wholly owned?

Interpretative Response:
The staff recognizes that the existence of outstanding public debt, preferred stock or a significant minority interest in a subsidiary might impact the parent’s ability to control the form of ownership. Although encouraging its use, the staff generally does not insist on the application of push down accounting in these circumstances. [Added by SAB No. 54, 11/3/83]

Question 3:
Company A borrows funds to acquire substantially all of the common stock of Company B. Company B subsequently files a registration statement in connection with a public offering of its stock or debt. Should Company B’s new basis (“push down”) financial statements include Company’s A debt related to its purchase of Company B?

Interpretative Response:
The staff believes that Company A’s debt, related interest expense and allocable debt issue costs should be reflected in Company B’s financial statements included in the public offering (or an initial registration under the Exchange Act) if: (1) Company B is to assume the debt of Company A, either presently or in a planned transaction in the future; (2) the proceeds of a debt or equity offering of Company B will be used to retire all or a part of Company A’s debt; or (3) Company B guarantees or pledges its assets as collateral for Company A’s debt.

Other relationships may exist between Company A and Company B, such as the pledge of Company B’s stock as collateral for Company A’s debt. While in this latter situation, it may be clear that Company B’s cash flows will service all or part of Company A’s debt, the staff does not insist that the debt be reflected in Company B’s financial statements providing there is full and prominent disclosure of the relationship between the Companies A and B and the actual or potential cash flow commitment. In this regard, the staff believes that Statements of Financial Accounting Standards Nos. 5 and 57 requires sufficient disclosure to allow users of Company B’s financial statements to fully understand the impact of the relationship on Company B’s present and future cash flows. Rule 4-08(e) of Regulation S-X (17 CFR 210.4-08(e)) also requires
disclosure of restrictions which limit the payment of dividends. Therefore, the staff believes that the equity section of Company B's balance sheet and any pro forma financial information and capitalization tables should clearly disclose that this arrangement exists.\(^{(4)}\)

Regardless of whether the debt is reflected in Company B's financial statements, the notes to Company B's financial statements should generally disclose, at a minimum: (1) the relationship between Company A and Company B; (2) a description of any arrangements that result in Company B's guarantee, pledge of assets or stock, etc. that provides security for Company A's debt; (3) the extent (in the aggregate and for each of the five years subsequent to the date of the latest balance sheet presented) to which Company A is dependent on Company B's cash flows to service its debt and the method by which this will occur; and (4) the impact of such cash flows on Company B's ability to pay dividends or other amounts to holders of its securities.

Additionally, the staff believes Company B's Management's Discussion and Analysis of Financial Condition and Results of Operations should discuss any material impact of the servicing of Company A's debt on its own liquidity pursuant to Item 303(a)(1) of Regulations S-K (17 CFR 229.303(a)(1)). (Added by SAB No. 73, 12/30/87.)

**RELEVANT LITERATURE**

**Statutory Accounting**
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 8 - Accounting for Pensions
- Issue Paper No. 11 - Compensated Absences
- Issue Paper No. 13 - Employers’ Accounting for Postemployment Benefits
- Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- SEC Staff Accounting Bulletin No. 73
Statutory Issue Paper No. 96

Other Liabilities

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the other liabilities is provided in Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies and Chapter 13, Other Liabilities, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies.

2. The purpose of this issue paper is to establish statutory accounting principles for other liabilities, including self-insurance reserves, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. For purposes of identifying other liabilities, the discussion, definition and accounting treatment outlined in Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5) must be considered. This paper is not an all inclusive list of other liabilities. Certain other liabilities are covered in other issue papers. All other liabilities, whether or not specifically identified in this issue paper shall be recorded and disclosed in accordance with Issue Paper No. 5, which states that “a liability shall be recorded on a reporting entity’s financial statements when incurred”.

4. Specific accounting treatment and where appropriate, a definition of certain other liabilities, is discussed below.

Self-Insurance

5. Self-insurance occurs when an entity retains insurance risks associated with the entity’s day-to-day operations that are commonly transferred to an insurer through an insurance contract. Self-insurance can also be described as a decision not to insure or non-insurance. To the extent that an event occurs, obligating the entity in accordance with the definition of a liability or impairment of an asset in Issue Paper No. 5, for which insurance coverage has not been obtained, the entity shall record either the appropriate write-down of the assets, if applicable, or reserves shall be established using the same estimation methodology an insurance company uses when an insurance contract is issued for the type of insurance risk which is self-insured. Issue Paper No. 55 - Unpaid Claims, Losses and Loss Adjustment Expenses describes the specific reserving guidance which should be followed.

6. The related costs should be treated similarly to comparable expenses and allocated appropriately (see Issue Paper No. 94 - Allocation of Expenses). As a result of this treatment, the costs are accounted for based on the nature of the underlying expenses.

7. The mere fact that a decision is made not to insure against losses that can reasonably be expected some time in the future does not necessitate accrual by the entity if it is not probable that an asset has been impaired or a liability incurred at the date of the financial statements.
Amounts Withheld or Retained by Company as Agent or Trustee

8. A reporting entity may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Amounts withheld or retained by an entity as trustee or agent shall be recorded as a liability when the salaries or other compensation are expensed (8(a and b)) or the funds are received (8(c, d and e)). Examples of such occurrences are:

a. As an employer, the reporting entity deducts and withholds federal and state income taxes, social security taxes, charitable contributions, savings plan deductions, garnishments, employee contributions to pension plans, employee share of group life and health insurance premiums, and other employee salary withholdings or deductions.

b. Amounts due under deferred compensation arrangements shall be accrued in accordance with the provisions of Issue Paper No. 14 – Employers’ Accounting for Postretirement Benefits Other Than Pensions. Segregated funds (i.e., Rabbi trusts and similar arrangements) shall not be netted against the accrued liability unless the requirements of Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities are met.

c. Many reporting entities invest in commercial and residential mortgages. The entity may require the mortgagor to prepay real estate taxes and property insurance premiums which the entity will hold in escrow and pay when due.

d. Deposits held by a reporting entity in connection with leases of investment property.

e. Any other funds the reporting entity may receive and hold in a fiduciary capacity.

Remittances and Items Not Allocated

9. Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. The reporting entity shall record a liability for these cash receipts when the funds are received. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:

a. Premium payments received with the application for policies which have not yet been issued;

b. Premium payments in an amount different than the amount billed by the reporting entity;

c. Unidentified cash receipts.

Interest Payable

10. Interest payable includes interest on borrowed money as well as interest on real estate and approved interest on surplus notes. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. The amount to be reported is the amount which has accrued and is unpaid at the balance sheet date. The Property and Casualty Annual Statement includes a specific line to record accrued interest. Accrued interest for Life and Accident and Health Companies shall be recorded with the liability.

Payable to Parent, Subsidiaries and Affiliates

11. A liability shall be established for expenditures incurred on behalf of the reporting entity by a parent, affiliates, or subsidiaries or for amounts owed through other intercompany transactions. Examples of such expenses are executive salaries, workers compensation insurance premiums, pension contributions, etc. The liability shall be identified as an intercompany balance.
12. Reinsurance transactions are not considered liabilities of this nature and are covered in Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance and Issue Paper No. 75 - Property and Casualty Reinsurance.

DISCUSSION

13. This issue paper adopts FASB Statement No. 116, Accounting for Contributions Received and Contributions made and AICPA Statement of Position 96-1, Environmental Remediation Liabilities.

14. The principles established are consistent with current statutory accounting principles and with Issue Paper No. 5. The requirement that liabilities be recorded when they are incurred is also consistent with the recognition principle described in the Statement of Concepts.

15. The liabilities addressed above are not specifically discussed in GAAP, however, they are considered liabilities and therefore are treated consistently with the GAAP guidance referenced in Issue Paper No. 5. The “Scope of the Statement” section of FASB Statement No. 5, Accounting for Contingencies, includes a reference to the fact that self-insurance is covered under the scope of the statement.

Drafting Notes/Comments
- Interest payable on surplus notes is addressed in Issue Paper No. 41 - Surplus Notes.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

16. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies discusses accounting for other liabilities as follows:

Amounts Withheld or Retained by Company as Agent or Trustee

The life insurance company may, in the normal course of its business, withhold funds as an agent or trustee which will ultimately be paid to others. Funds held must be identified as to whom they are held for, as well as the amount, so that the liability can be confirmed by subsequent payments or confirmation by the payee. Examples of such occurrences are:

1. As an employer, the life insurance company deducts and withholds federal and state income taxes, social security taxes, employee contributions to pension plans, and employees’ share of group life and health insurance premiums. Such funds are recorded as a liability of the company at the time gross salaries are expensed and the liability is subsequently cleared by payment.

2. Many life insurance companies invest in commercial and residential mortgages. The company may require the mortgagor to prepay real estate taxes and property insurance premiums which the company will hold in escrow and pay when due.

3. Any other funds the company may receive and hold in a fiduciary capacity.

Remittances and Items Not Allocated

Cash receipts cannot always be identified for a specific purpose or, for other reasons, applied to a specific account when received. It is undesirable, costly, and imprudent for a company to delay depositing such receipts until the payment can be identified. Cash receipts should be deposited intact when received for good accounting control and to be available for investment by the company. It is customary for life insurance companies to maintain one or more liability accounts to record cash receipts which cannot be specifically allocated. Such liability accounts are generally referred to as suspense accounts. Examples of such receipts include:
1. Premium payments received with the application for policies which have not yet been issued;

2. Premium payments of amount different than the amount billed by the company;

3. Unidentified cash receipts.

Special attention should be given to the verification and clearance of suspense accounts. The outstanding suspense items should be aged. Any suspense item that has not been cleared after a specified time should be investigated. If premium payments are allowed to remain in suspense for a long period of time, it is possible that a policy might be improperly lapsed for nonpayment of premium or have nonforfeiture options or automatic premium loan options applied.

**Payable to Parent, Subsidiaries and Affiliates**

A liability should be established for amounts payable to a parent, subsidiary or affiliate for intercompany disbursements. Examples of such expenses are executive salaries, workers compensation insurance premiums, pension contributions, etc. The purpose of separating this liability from other accounts is to identify intercompany balances.

17. Chapter 13 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Other Liabilities, discusses accounting for other liabilities as follows:

Other liabilities are those liabilities not specifically covered by other chapters. Included in this category are the following annual statement captions:

- Borrowed Money
- Interest Payable
- Stockholder Dividends Declared and Unpaid
- Policyholder Dividends Declared and Unpaid
- Amounts Withheld or Retained by Company for Account of Others
- Provision for Reinsurace
- Excess of Statutory Reserves over Statement Reserves
- Net Adjustments in Assets and Liabilities Due to Foreign Exchange Rates
- Liability for Amounts Held Under Uninsured Accident and Health Plans
- Drafts Outstanding
- Payable to Affiliates
- Payable for Securities
- Debt Obligations of Employee Stock Ownership Plans
- Postretirement Benefits Other Than Pensions

**Interest Payable**

Interest payable includes interest on “Borrowed Money” as well as interest on real estate and surplus loans. It also includes interest on funds held as a deposit or security, such as those held by a ceding company against a reinsurer. Further treatment of funds held by a ceding company may be found in Chapter 22-Reinsurance.

The interest on “Borrowed Money” is also shown parenthetically as part of the caption of this liability item in the annual statement.

**Amounts Withheld or Retained by Company for Account of Others**

Items to be included under this classification are:

1. Amounts withheld from employee payrolls and unpaid at the balance sheet date. These include federal, state and city taxes and social security taxes, savings bonds deductions, charitable contributions, savings plan deductions, employee retirement plan
contributions, garnishments, group life and health insurance premiums, and other employee salary withholdings or deductions.

2. Deposits held by the company in connection with leases of investment property.

3. Escrow balances required of mortgagors for property taxes and insurance on real estate pledged for mortgages held by the company.

4. Any other funds the company holds in a fiduciary capacity for the account of others. This excludes reinsurance funds held, which are reported elsewhere and covered in Chapter 22-Reinsurance.

Payable to Affiliates

Amounts shown under this caption include unreimbursed expenditures on behalf of the company by a parent, affiliates, or subsidiaries or amounts owing through other intercompany transactions.

Reinsurance transactions are not normally reported on this line. For further information, see Chapter 22-Reinsurance.

Generally Accepted Accounting Principles

18. FASB Statement No. 5, Accounting for Contingencies

SCOPE OF THIS STATEMENT

56. Some respondents to the Exposure Draft proposed that the Statement not deal with accrual and disclosure of loss contingencies in general but, rather, only with the following three specific matters: "self-insurance," risk of losses from catastrophes assumed by property and casualty insurance companies including reinsurance companies, and threat of expropriation.

57. The Board has concluded, however, that the broad issue of accrual and disclosure of loss contingencies should be dealt with in a single Statement, just as the Discussion Memorandum encompasses "the broad issue of accounting for future losses." As the Discussion Memorandum stated, "future losses of all types presently known to affect enterprises and new types of future losses that may arise are conceptually included in the scope of this project."

RISK OF FUTURE LOSS OR DAMAGE OF ENTERPRISE PROPERTY, INJURY TO OTHERS, DAMAGE TO THE PROPERTY OF OTHERS, AND BUSINESS INTERRUPTION

85. Some persons contend that the decision not to purchase insurance against losses that can be reasonably expected some time in the future (such as risk of loss or damage of enterprise property, injury to others, damage to the property of others, and business interruption) justifies periodic accrual for those losses without regard to whether it is probable that an asset has been impaired or a liability incurred at the date of the financial statements. As a basis for their position, they frequently cite the following factors: matching of revenue and expense, spreading the burden of irregularly occurring costs to successive generations of customers, and conservatism. They also believe that accrual of estimated losses from those types of risks improves the comparability of the financial statements of enterprises that purchase insurance. Some contend that a prohibition against periodic accrual for uninsured losses will force enterprises to purchase insurance coverage that would not otherwise be purchased.

86. In the Board’s judgment, however, the mere existence of risk, at the date of an enterprise’s financial statements, does not mean that a loss should be accrued. Anticipation of asset impairments or liabilities or losses from business interruption that do not relate to the current or a prior period is not justified by the matching concept.

87. The Board’s view regarding the contention that periodic accrual for uninsured losses is a way of providing protection against loss and improving comparability among enterprises that do
not purchase insurance, and the contention that prohibition of accrual will force enterprises to purchase insurance are discussed in paragraphs 61-66. The Board’s position regarding periodic accrual for uninsured risks and other loss contingencies on the grounds of spreading the burden of irregularly occurring costs to successive generations of customers or on the grounds of conservatism is discussed in paragraphs 81-84.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 13
- Issue Paper No. 14 - Employers’ Accounting for Postretirement Benefits Other Than Pensions
- Issue Paper No. 76 - Offsetting and Netting of Assets and Liabilities
- Issue Paper No. 74 - Life, Deposit-Type and Accident and Health Reinsurance
- Issue Paper No. 75 - Property and Casualty Reinsurance

Generally Accepted Accounting Principles
- FASB Statement No. 5, Accounting for Contingencies
- FASB Statement No. 116, Accounting for Contributions Received and Contributions Made
- AICPA Statement of Position 96-1, Environmental Remediation Liabilities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 97

Underwriting Pools and Associations Including Intercompany Pools

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Underwriting pools and associations can be categorized as follows: involuntary, voluntary, and intercompany.

2. Involuntary pools represent a mechanism employed by states to provide insurance coverage to those with higher than average probability of loss who otherwise would be excluded from obtaining coverage. Reporting entities are generally required to participate in the underwriting results, including premiums, losses, expenses, and other operations of involuntary pools, based on their proportionate share of similar business written in the state. Involuntary plans are also referred to as residual market plans, involuntary risk pools, and mandatory pools.

3. Voluntary pools are similar to involuntary pools except they are not state mandated and a reporting entity participates in the pool voluntarily. In addition, voluntary pools are not limited to the provision of insurance coverage to those with higher than average probability of loss, but often are used to provide greater capacity for risks with exceptionally high levels of insurable values (e.g., aircraft, nuclear power plants, refineries, and offshore drilling platforms).

4. Intercompany pooling relates to business which is pooled among affiliated entities who are party to a pooling arrangement.

5. Current statutory accounting provides limited guidance on accounting for a reporting entity’s participation in underwriting pools and associations. Although it is not specifically stated in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies (Life/A&H and P&C Accounting Practices & Procedures Manuals), certain annual statement schedules do require that the reporting entity’s participation in the pools’ underwriting results be recorded on a gross basis. However, the guidance does not address whether participation in the pools should be recorded using accrual or cash basis accounting. Reporting entities are currently utilizing both approaches. GAAP guidance related to underwriting pools and associations is limited to FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts (FAS 113). FAS 113 states that involuntary plans are included within the scope of the statement; therefore the reinsurance activity should be recorded on a gross basis.

6. The purpose of this issue paper is to establish statutory accounting principles for underwriting pools and associations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

7. Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets (Issue Paper No. 5), defines a liability and states that the definition “includes but is not limited to liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims).” Issue Paper No. 5 requires liabilities to be recorded on a reporting entity’s financial statements when incurred.
8. Participation in a pool may be on a joint and several basis, i.e., in addition to a proportional share of losses and expenses incurred by the pool, participants will be responsible for their share of any otherwise unrecoverable obligations of other pool participants. In certain instances, one or more entities may be designated as servicing carriers for purposes of policy issuance, claims handling, and general administration of the pooled business, while in other cases a pool manager or administrator performs all of these functions and simply bills pool participants for their respective shares of all losses and expenses incurred by the pool. In either case, liabilities arising from pooled business are generally incurred on a basis similar to those associated with non-pooled business, and should therefore be treated in a manner consistent with the guidelines set forth in Issue Paper No. 5 and in paragraph 7 of this issue paper.

9. Intercompany pooling arrangements involve establishment of a conventional quota share reinsurance agreement under which all of the pooled business is ceded to the lead entity and then retroceded back to the pool participants in accordance with their stipulated shares. In such arrangements, only the policy issuing entity has direct liability to its policyholders or claimants; other pool participants are liable as reinsurers for their share of the issuing entity’s obligations. Although participants may use different assumptions (e.g., discount rates) in recording transactions, the timing of recording transactions shall be consistently applied by all participants.

10. Underwriting results shall be accounted for on a gross basis whereby the participant’s portion of premiums, losses, expenses, and other operations of the pools are recorded separately in the financial statements rather than netted against each other. Premiums and losses shall be recorded as direct, assumed, and/or ceded as applicable. If the reporting entity is a direct writer of the business premiums, losses shall be recorded as directly written and accounted for in the same manner as other business which is directly written by the entity. To the extent that premium is ceded to a pool, premiums and losses shall be recorded in the same manner as any other reinsurance arrangement. A reporting entity who is a member of a pool shall record its participation in the pool as assumed business as in any other reinsurance arrangement.

11. Equity interests in, or deposits receivable from, a pool represent cash advances to provide funding for operations of the pool. These are admitted assets and shall be recorded separately from receivables and payables related to a pool’s underwriting results. Receivables and payables related to underwriting results should be accounted for in accordance with the guidance in paragraphs 7 to 10, above. If, in accordance with Issue Paper No. 5, it is probable that these receivables are uncollectible, any uncollectible amounts shall be written off against operations in the period such determination is made. If it is reasonably possible a portion of the balance is uncollectible but is not written off, disclosure requirements outlined in Issue Paper No. 5 shall be followed.

12. If a reporting entity is part of a group of affiliated entities which utilizes a pooling arrangement under which the pool participants cede substantially all of their direct and assumed business to the pool, the financial statements shall include:

   a. A description of the basic terms of the arrangement and the related accounting;
   b. Identification of the lead entity and of all affiliated entities participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business;
   c. Description of the lines and types of business subject to the pooling agreement;
   d. Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead entity;
e. Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements;

f. Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead entity and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants;

g. Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write-off of uncollectible reinsurance.

DISCUSSION

13. This issue paper applies Issue Paper No. 5 to underwriting pools and associations.

14. There are a variety of types of underwriting pools and associations. Examples include, but are not limited to Assigned Risk Plans, Joint Underwriting Associations, Reinsurance Pools, Fair Access to Insurance Requirements Plans, Comprehensive Health Insurance Plans, and Workers Compensation Pools.

15. Certain underwriting pools and associations, such as Assigned Risk Plans, require the reporting entity to accept a share of the undesirable risks based on the percent of the premium written in that state. The reporting entity is then responsible for collecting premiums and paying claims on policies issued to these applicants. Other underwriting pools and associations, such as Joint Underwriting Associations, require all entities in the state to participate in the underwriting results, however, a servicing company is designated to issue the policies and pay the claims for these risks on behalf of the pool.

16. Current statutory practice related to underwriting pools and associations is varied. A “pay-as-you-go” (cash basis) approach has been adopted by many entities. This issue paper rejects that treatment because it is inconsistent with the concepts of conservatism and recognition outlined in the Statement of Concepts. It is also inconsistent with the accounting principles set forth in Issue Paper No. 5. With respect to conservatism, the Statement of Concepts states:

Financial reporting by insurance enterprises requires the use of substantial judgments and estimates by management. In order to provide a margin of protection to policyholders, the concept of conservatism should be followed when developing estimates as well as establishing accounting principles for statutory reporting.

17. With respect to recognition, the Statement of Concepts states that:

“Liabilities require recognition as they are incurred. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.”

18. Many reporting entities have adopted the practice of netting the underwriting results related to their participation in underwriting pools and associations. Although the Life/A&H and P&C Accounting Practices and Procedures Manuals do not specifically state that the reporting entity’s participation in the pool’s underwriting results shall be recorded on a gross basis, the Annual Statement Instructions for Property and Casualty Insurance Companies require a separate disclosure of “the net reserves for losses and expenses for the entity’s share of underwriting pools’ and associations’ unpaid loss and expenses which are included in reserves.” The instructions also require that reinsurance assumed from and ceded to underwriting pools and associations be disclosed separately thereby establishing the requirement to record reinsurance on a gross basis.
19. All forms of underwriting pools and associations should be accounted for consistently. It would be inconsistent to require reporting entities to account for underwriting results related to assigned risk plans on a gross basis and underwriting results related to joint underwriting associations on a net basis. Accounting for the plans consistently enables regulators to more effectively compare results of the individual entities participating in the plans.

20. The consistency requirement of paragraph 19 is supported by the Statement of Concepts which states that:

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

21. There is no specific GAAP guidance related to underwriting pools and associations other than in FAS 113 which states that involuntary risk pools are included within the scope of the statement and thereby requires the reinsurance activity to be recorded on a gross basis.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
22. The P&C Accounting Practices and Procedures Manual, Chapter 14, *Premiums*, discusses the following:

*Underwriting Pools, Associations, and Syndicates*
Companies also participate as members of an underwriting pool, association, or syndicate organized to provide special insurance coverages. Operating results, including the applicable premiums, are distributed to member companies based on their prescribed share.

Usually, statements are received by the company showing the total premiums written, as well as the member company’s participation. These premiums are recorded on a summary basis (usually by line of business) as direct or assumed business depending on the requirements of the particular association.

23. The P&C Accounting Practices and Procedures Manual, Chapter 22, *Reinsurance*, discusses the following:

Fronting arrangements, servicing carrier business, and pools and association business are often accomplished using reinsurance contracts. The guidance included in this chapter also applies to these types of contracts, except as specifically exempted.

24. The Annual Statement Instructions for Property and Casualty Insurance Companies, General Section, discusses the following requirements related to the actuarial opinion:

8. The scope paragraph should contain a sentence such as the following:

"I have examined the actuarial assumptions and methods used in determining reserves listed below, as shown in the Annual Statement of the Company as prepared for filing with state regulatory officials, as of December 31, 19__.”

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The paragraph should list items and amounts with respect to which the actuary is expressing an opinion. The list should include but not necessarily be limited to:

A. Reserve for Unpaid Losses (Page 3, Line 1);
B. Reserve for Unpaid Loss Adjustment Expenses (Page 3, Line 2);
C. Reserve for Unpaid Losses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 13 and 15); and
D. Reserve for Unpaid Loss Adjustment Expenses - Direct and Assumed (Schedule P, Part 1, Totals from Cols. 17, 19, and 22).

If the actuary includes the Excess of Statutory over Statement Reserves to the above list, the actuary must also opine on the reserves excluding this amount.

9. The actuary should state that the items in paragraph 8, on which he or she is expressing an opinion, reflect the following items:

A. ...
B. ...
C. The net reserves for losses and expenses for the company’s share of voluntary and involuntary underwriting pools’ and associations’ unpaid losses and expenses which are included in reserves shown on Page 3 - Liability, Surplus and Other Funds, Lines 1 and 2, $__________.

11. The actuary should comment in the scope section on each of the following topics, describing the effect of each on loss or loss expense reserves: ...underwriting pools or associations, ...

25. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Assets, discusses the following disclosure requirement:

Line 17 - Equities and Deposits in Pools and Associations

In the event that the insurer has equity in, or deposits receivable from, underwriting associations, pools, etc., the equity interests and deposits receivable should be reported here.

26. The Annual Statement Instructions for Property and Casualty Insurance Companies, Section referring to Schedule F-Part 1-Assumed Reinsurance and Schedule F-Part 3-Ceded Reinsurance, requires reinsurance assumed from and ceded to mandatory pools and associations be disclosed separately from voluntary pools and associations.

27. The Property and Casualty Reinsurance Study Group of the Accounting Practices and Procedures (EX4) Task Force adopted the following disclosure requirements for intercompany pooling arrangements at its September 29, 1996 meeting.
PROPOSED INSTRUCTIONS
PROPERTY/CASUALTY ANNUAL STATEMENT FOOTNOTE

Intercompany Pooling Arrangements

Instruction:

If the company is part of a group of affiliated insurers which utilizes a pooling arrangement that affects the solvency and integrity of the insurer’s reserves under which the pool participants cede substantially all of their direct and assumed business to the pool, describe the basic terms of such arrangement[s] and the related accounting. The disclosure should include:

- Identification of the lead company and of all affiliated companies participating in the intercompany pool (include NAIC Company Codes) and indication of their respective percentage shares of the pooled business.
- Description of the lines and types of business subject to the pooling agreement.
- Description of cessions to non-affiliated reinsurers of business subject to the pooling agreement, and indication of whether such cessions were prior to or subsequent to the cession of pooled business from the affiliated pool members to the lead company.
- Identification of all pool members which are parties to reinsurance agreements with non-affiliated reinsurance reinsurers covering business subject to the pooling agreement and which have a contractual right of direct recovery from the non-affiliated reinsurer per the terms of such reinsurance agreements.
- Explanation of any discrepancies between entries regarding pooled business on the assumed and ceded reinsurance schedules of the lead company and corresponding entries on the assumed and ceded reinsurance schedules of other pool participants.
- Description of intercompany sharing, if other than in accordance with the pool participation percentage, of the Provision for Reinsurance (Schedule F, Part 7) and the write–off of uncollectible reinsurance.

Illustration

ALTERNATIVE 1: EXTERNAL REINSURANCE PRIOR TO POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property-casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company after each individual company’s external reinsurance is transacted among third parties. This pool of property-casualty net underwriting risks is then retroceded from the lead company to the other non-lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group’s intercompany pooling arrangement are as follows:

<table>
<thead>
<tr>
<th>Pool Participant</th>
<th>NAIC Company Code</th>
<th>Pool Participation %</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ABC Insurance Company</td>
<td>000001</td>
<td>75%</td>
</tr>
<tr>
<td>The ABC Casualty Company</td>
<td>0000100002</td>
<td>10%</td>
</tr>
<tr>
<td>The ABC Indemnity Company</td>
<td>00003</td>
<td>10%</td>
</tr>
<tr>
<td>ABC Fire Insurance Company</td>
<td>00004</td>
<td>5%</td>
</tr>
</tbody>
</table>
ALTERNATIVE 2: EXTERNAL REINSURANCE AFTER POOLING

The Company participates in an intercompany reinsurance pooling arrangement in which The ABC Insurance Company is the lead company. Under the terms of the arrangement, all of the property–casualty underwriting risks of the intercompany pool participants except other accident & health are reinsured with the lead company. After reinsurance is transacted among third parties by the lead company, the remaining pool of property-casualty underwriting risks is the then retroceded to the other non–lead pool participants based on pool participation percentages.

The names, NAIC company codes and pool participation percentages of the ABC Group’s intercompany pooling arrangement are as follows:

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<th>Pool Participant</th>
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</tr>
<tr>
<td>ABC Fire Insurance Company</td>
<td>00004</td>
<td>5%</td>
</tr>
</tbody>
</table>

Generally Accepted Accounting Principles

29. FAS 113 discusses the following:

50. Several respondents questioned whether servicing carriers for involuntary risk pools should be included in the Statement's scope. Servicing carriers generally retain the primary obligation to the policyholder and have no right to offset claim liabilities against amounts due from other pool participants. Although the credit risk associated with involuntary pools may be reduced because of the pool membership’s joint and several liability, the servicing carrier is still dependent on the ability of other pool members to pay their proportionate share of claims. State authorities oversee such pools and may act to support the solvency of pool, but that action generally is voluntary. The Board concluded that it was unable to effectively distinguish servicing carrier business from other types of reinsurance for accounting purposes. Separate presentation or disclosure of servicing carrier activity is not precluded by this Statement.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 14 and 22
- The Annual Statement Instructions for Property and Casualty Insurance Companies
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets

Generally Accepted Accounting Principles
- AICPA Audit and Accounting Guide: Audits of Property and Casualty Insurance Companies, Chapter 1, Nature, Conduct, and Regulation of the Business, Section 1.08
- FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

State Regulations
- No additional guidance obtained from state statutes or regulations.
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Statutory Issue Paper No. 99

Nonapplicable GAAP Pronouncements

STATUS
Updated for actions taken by the Statutory Accounting Principles Working Group through December 6, 2004

Type of Issue:
Common Area

SUMMARY OF ISSUE
1. This statement addresses Generally Accepted Accounting Principles (GAAP) pronouncements that are nonapplicable due to one of the following reasons:
   a. The pronouncement does not relate to the insurance industry;
   b. The pronouncement is not within the objectives of statutory accounting;
   c. The pronouncement would not add a substantive amount of guidance to statutory accounting due to the narrow scope of the topic;
   d. The pronouncement relates to transition of a previously issued GAAP pronouncement.

SUMMARY CONCLUSION
2. GAAP pronouncements in levels 1, 2, and 3 of the GAAP hierarchy not considered applicable to the codification project are summarized as follows:

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</thead>
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</thead>
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**DISCUSSION**

3. This issue paper rejects the nonapplicable GAAP pronouncements listed in the Summary Conclusion.

**Drafting Notes/Comments**

None

**RELEVANT LITERATURE**

**Statutory Accounting**

None

**State Regulations**

- No additional guidance obtained from state statutes or regulations
Statutory Issue Paper No. 100

Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment

STATUS
Finalized June 23, 1998

Type of Issue
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets, commonly referred to as “health care delivery assets”, are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

2. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets - supplies, pharmaceuticals and surgical supplies, and durable medical equipment that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Supplies, pharmaceuticals and surgical supplies, and durable medical equipment meet the definition of assets established in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Pharmaceuticals and surgical supplies, and durable medical equipment held by reporting entities and used for the direct delivery of health care services are assets which are used to fulfill policyholder obligations within the meaning of Issue Paper No. 4 and are admitted assets to the extent that they conform to the requirements of this issue paper.

4. The reporting entity shall maintain a control system that provides for identification of quantities on hand and appropriate valuation (lower of cost or market) of supplies, pharmaceuticals and surgical supplies, and durable medical equipment.

5. Supplies except for pharmaceuticals and surgical supplies discussed in paragraph 6 (e.g., linens, uniforms and garments, food and other commodities, and housekeeping, maintenance, and office supplies) shall be nonadmitted assets.

6. Pharmaceutical and surgical supplies (e.g. drugs, surgical items (such as implants), and medical dressings) used directly in the treatment of medical conditions shall be admitted assets.

7. Durable medical equipment includes consumable or salable equipment such as wheelchairs, crutches and braces, that is generally classified as inventory, and is of a nature that it may be reused. Subscribers, members or policyholders may utilize durable medical equipment on a temporary basis and later return the equipment to the provider. The provider shall recognize the diminution in value, if any, as a result of use of such equipment.
8. In accordance with the reporting entity’s capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, and durable medical equipment may be expensed when purchased.

**DISCUSSION**

9. Supplies as defined in this issue paper are nonadmitted assets because they are consumed in the normal operations of a hospital or medical facility and would generally have limited or no value in the event of liquidation.

10. Pharmaceuticals and surgical supplies, and durable medical equipment are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements, they are tightly controlled and the nature of such items would generally permit the recovery of costs upon liquidation.

11. This issue paper rejects the AICPA Audit and Accounting Guide: Health Care Organizations.

12. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

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

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

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

13. The Health Maintenance Organization Model Act, dated July 1995 states the following:

    **Section 5. Powers of Health Maintenance Organizations**

    A. The powers of a health maintenance organization include, but are not limited to, the following:

    (1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;

    **Section 12. Investments**

    With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]
Generally Accepted Accounting Principles
14. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

   6.02. Supplies usually are not material to the financial position of health care organizations. However, because of the volume of supply transactions, they may materially affect operations. Supplies typically include medical and surgical supplies; pharmaceuticals; linens; uniforms, and garments; food and other commodities; and housekeeping, maintenance, and office supplies.

   6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

Other Sources of Information
15. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk-Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Health Maintenance Organization Model Act, dated July 1995
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- The AICPA Audit and Accounting Guide: Health Care Organizations

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996

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Statutory Issue Paper No. 101

Health Care Delivery Assets - Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities

STATUS
Finalized June 23, 1998

Type of Issue:
Health Entities

SUMMARY OF ISSUE

1. This issue paper applies only to reporting entities which directly provide health care services to subscribers, members or policyholders. Such providers acquire and retain assets not directly addressed in current statutory guidelines. These assets commonly referred to as “health care delivery assets”, are assets used in connection with the direct delivery of health care services in facilities owned or operated by the reporting entity and include furniture, medical equipment and fixtures and leasehold improvements.

2. Furniture, medical equipment and fixtures used in connection with the direct provision of health care services include diagnostic equipment, laboratory equipment, patient monitoring equipment, hospital beds, examining tables, and operating room equipment.

3. The purpose of this issue paper is to establish statutory accounting principles for health care delivery assets - furniture, medical equipment and fixtures and leasehold improvements in health care facilities that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Furniture, medical equipment and fixtures, and leasehold improvements in health care facilities owned or operated by the reporting entity meet the definition of assets established in Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets (Issue Paper No. 4). Furniture, medical equipment and fixtures, and leasehold improvements held by health reporting entities and used for the direct delivery of health care services are admitted assets to the extent that they conform to the requirements of this issue paper. Furniture, fixtures and equipment, and leasehold improvements which are not used in the direct delivery of health care (e.g., for administrative activities including claims processing, billing, and maintenance of medical records) are nonadmitted assets and are addressed in Issue Paper No. 19 - Furniture, Fixtures, and Equipment and Issue Paper No. 31 - Leasehold Improvements Paid by the Reporting Entity as Lessee, respectively.

5. These assets shall be depreciated over their estimated useful lives but for a period not to exceed three years, except for a leasehold improvement which shall be amortized against net income over the shorter of its estimated useful life or the remaining life of the original lease excluding renewal or option periods, using methods detailed in Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements.

6. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.
DISCUSSION

7. Furniture, medical equipment and fixtures and leasehold improvements in health care facilities owned or operated by the reporting entity used in the direct delivery of health care are admitted assets as defined in this issue paper because they are used to fulfill benefit requirements.

8. The AICPA Audit and Accounting Guide: Health Care Organizations is rejected in Issue Paper No. 100 - Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, and Durable Medical Equipment.

9. The statutory accounting principles established in this issue paper are consistent with the recognition concept in the Statement of Concepts which states:

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

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

Drafting Notes/Comments

- Land and building, including health care facilities, are addressed in Issue Paper No. 23 - Property Occupied by the Company.
- Electronic Data Processing Equipment and Software are addressed in Issue Paper No. 16 - Electronic Data Processing Equipment and Software.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 5, Other Admitted Assets) states:

INVESTMENTS INVOLVING EQUIPMENT

The statutory method of accounting for equipment arrangements is governed largely by the form of the agreement to which the HMO is a party.

11. The Accounting Practices and Procedures Manual for Health Maintenance Organizations (Chapter 6, Nonadmitted Assets) states:

COMMON EXAMPLES

Some examples of assets which are non-admitted due to either an uncertainty as to their collectibility or an insufficient basis for determining their valuation or for other reasons are:

(6) net book value of equipment and furniture (except certain electronic data processing equipment and medical equipment)
12. The Health Maintenance Organization Model Act, dated July 1995 states the following:

**Section 5. Powers of Health Maintenance Organizations**

A. The powers of a health maintenance organization include, but are not limited to, the following:

   (1) The purchase, lease, construction, renovation, operation or maintenance of hospitals, medical facilities, or both, and their ancillary equipment, and property reasonably required for its principal office or for purposes necessary to the transaction of the business of the organization;

**Section 12. Investments**

With the exception of investments made in accordance with Section 5A(1), the funds of a health maintenance organization shall be invested only in accordance with [cite section of law or regulation implementing the NAIC Health Maintenance Organization Investment Guidelines.]

**Generally Accepted Accounting Principles**

13. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

6.01. Health care organizations use various types of property and equipment. Those assets may be material to the financial position of institutional health organizations, such as hospitals and nursing homes. Typical accounts used to record property and equipment transactions are land, land improvements, buildings and improvements, leasehold improvements, equipment (fixed and movable), leased property and equipment, accumulated depreciation and amortization, and construction in progress.

6.04. Accounting for property and equipment, supplies, and other assets of health care organizations is similar to that used by other business organizations.

6.05. Depreciation and amortization of property and equipment are recorded in conformity with GAAP. Useful lives assigned to depreciable assets should be reasonable, based on the circumstances. The American Hospital Association publishes useful guidelines for classifications and estimated useful lives for property and equipment used by hospitals. Those guidelines also may be useful to other health care organizations. If there is a potential that an asset is impaired, health care organizations should consider the guidance in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.*

**Other Sources of Information**

14. The NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996 conducted by the Risk Based Capital Task Force surveyed the state insurance departments that regulate HMOs to determine if and to what degree that they allow HMOs to admit health care delivery assets. Responses from 38 state insurance departments indicated that the vast majority admit such assets at book value. A number of state insurance departments noted that they do place varying limits on the amount of certain health care delivery assets that can be admitted. However, none of the respondent states indicated that they did not admit such assets.

**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Health Maintenance Organization Model Act, dated July 1995
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets

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- Issue Paper No. 16 - Electronic Data Processing Equipment and Software
- Issue Paper No. 19 - Furniture, Fixtures and Equipment
- Issue Paper No. 23 - Property Occupied by the Company
- Issue Paper No. 31 - Leasehold Improvements Paid by the Reporting Entity as Lessee
- Issue Paper No. 67 - Depreciation of Property and Amortization of Leasehold Improvements

**Generally Accepted Accounting Principles**
- The AICPA Audit and Accounting Guide: Health Care Organizations

**State Regulations**
- No additional guidance obtained from state statutes or regulations.

**Other Sources of Information**
- NAIC Survey on State Practice Regarding Admissibility of Health Care Delivery Assets dated January 1996
Statutory Issue Paper No. 103

Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell

STATUS
Finalized June 13, 2000

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Insurance–linked securities are fully funded corporate securities with special language that requires the securityholder to forgive or defer some or all payments of interest or principal if actual insurance losses surpass a specified amount, or trigger event. Should a triggering event occur, an insurer or reinsurer that issued insurance-linked securities can pay claims with all or a portion of the securityholder proceeds. To the extent that securityholders proceeds are at risk of loss, the insurer or reinsurer can write down its liability for the securities, and recognize a surplus benefit in an equal amount.

2. Chapter 1 of the Accounting Practices and Procedures Manual for Property/Casualty Insurance Companies does not specifically address accounting for the issuers of insurance-linked securities issued through a protected cell. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133 - Accounting for Derivative Instruments and Hedging Activities (FAS 133) dictates that these types of contracts would be accounted for as reinsurance.

3. The purpose of this issue paper is to provide guidance for protected cells that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Definitions

4. The Protected Cell Model Act (included in its entirety in the Relevant Statutory Accounting and GAAP Guidance section) includes a complete listing of definitions used in this issue paper.

General

5. An insurance-linked security can be issued by the insurer through a protected cell for purchase by investors. A protected cell is retained within the insurance or reinsurance company and is used to insulate the proceeds of the securities offering from the general business risks of the insurer, granting an additional comfort level for investors of the securitized instrument. The insurance exposures that have been securitized by the insurance-linked security are attributed to the protected cell.

6. Under the terms of the security, the principal may be paid to the investor on a specified maturity date, with interest, unless a trigger event occurs. The proceeds of the security offering will collateralize (i) the issuer's obligation under an insurance or reinsurance agreement if a trigger event occurs and (ii) the issuer's obligation to repay the security if a trigger event does not occur.

7. If the trigger event takes place before a specified date, the issuer is relieved of some or its entire obligation to repay the securityholders, and the investor incurs a loss of some or all of its investment. The security must be issued with an indemnity trigger.
8. In an insurance-linked security, the insurer that originated the transaction has hedged its portfolio of insurance risks by transferring certain of those risks to the securityholders. Should the triggering event occur, the issuer would incur a loss that would be partly offset by the amount of liability to securityholders from which it is relieved. This issue paper provides statutory accounting guidance solely for indemnity triggered insurance securitization transactions conducted through a protected cell.

**Accounting for Prefunded Insurance-Linked Securities for Business Attributed to the Protected Cell from the General Account**

**General Account Reporting**

9. Activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, and claims processing are activities of the insurance company distinct from the protected cell and shall be accounted for as transactions of the general account.

10. Amounts paid to the protected cell for underwriting risks, which ultimately will be securitized by the protected cell, shall be reported separately as a reduction of written and earned premiums in the current period general account’s statement of income. This premium is earned by the general account in accordance with Issue Paper No. 53 - Property Casualty Contracts–Premiums.

11. At the maturity of the protected cell all assets and liabilities of the protected cell are distributed based on the contractual agreement with the securityholders. If after this distribution assets still reside in the protected cell, these assets shall be attributed to the general account and recognized as an adjustment to surplus.

12. Insurance claim liabilities arising from past insurable events attributed to the protected cell account from the general account shall be accounted for as retro-active reinsurance as prescribed in Issue Paper No. 75 - Property and Casualty Reinsurance.

13. General account recoverables from the protected cell as a result of an indemnity based securitized event, shall be recognized separately as a reduction of gross losses and loss expenses incurred in the current period general account’s statement of income. General account recoverables from the protected cell on unpaid reported and incurred but not reported losses and loss adjustment expenses shall be netted against the liability for gross losses and loss adjustment expenses in the general account’s balance sheet. Recoverables from the protected cell shall not exceed the assets carried at fair value in the protected cell.

14. The general account shall include an aggregate write-in for the total assets and an aggregate write-in for liabilities of any protected cell which it maintains. Transfers to the general account due or accrued shall be reported on a net basis so that the asset and the liability totals of the general account are not overstated.

**Protected Cell Reporting**

15. The protected cell annual statement is concerned with the investment activities and obligations relating to insurance-linked securities attributed to that protected cell. As a result, the protected cell statement shall report only the financial activities of the protected cell and shall not include general account expenses related to insurance activities which are recorded for in the general account.

16. The protected cell shall record premium income for transactions attributed to it by the general account as income reported in the protected cell’s statement of income. This premium attribution is earned by the protected cell in accordance with Issue Paper No. 53 - Property and Casualty Premium.
17. The obligation from the issuance of the insurance-linked security is recorded as Funds Held Under Securitization Agreement, a liability on the protected cell balance sheet which is reported at its contractual value which will be the lower of the scheduled amount to be repaid to investors or the fair value of the investments in the protected cell. All protected cell assets shall be reported at fair value. Interest expenses payable to securityholders associated with the protected cell investment operations shall be deducted in the determination of net operating income of the cell. Net investment income and realized capital gains and losses relating to the investment operations of the protected cell are recorded as net investment income. Payables to the general account shall not exceed the assets carried at fair value in the protected cell.

18. Changes in both (i.) the fair value of the protected cell invested assets and (ii.) the protected cell contractual (or discounted) value of liabilities to investors shall be reported as an unrealized gain/loss in the equity section of the protected cell balance sheet.

19. When the trigger event occurs with respect to the underlying exposures attributed to the protected cell, the protected cell shall record the appropriate incurred losses in its current period statement of income. Correspondingly, the Funds Held Under Securitization Agreement shall be reduced and offset by gross losses incurred in the current period Statement of Income. The applicable funds to cover the subject exposure are then attributed to the general account via a balance sheet account, “Due to/from the General Account.”

20. If the trigger event does not take place on or before the contractual maturity date, the protected cell repays the bond principal as prescribed in the debt contract by reducing Funds Held Under Securitization Agreement.

Disclosures

General Account

21. Prior to the adoption of formal blanks changes by the NAIC Blanks Task Force, the general account shall reflect all activities with its protected cells as an aggregate write-in in its statutory balance sheet and income statement. The general account shall also disclose in its notes to the financial statements the types and amounts of exposures /risks attributed to each of its protected cells.

Protected Cells

22. Each protected cell of a protected cell company shall prepare and submit to all states where the protected cell company is licensed and the NAIC the following supplemental financial information:

   a. Balance Sheet
   b. Income Statement
   c. Statement of Cash Flows
   d. Investment Schedules as typically required for a property/casualty insurer
   e. Schedule P

DISCUSSION

23. This issue paper prescribes the accounting for the issuance of insurance-linked securities issued by a property and casualty insurer through a protected cell. This guidance was adopted by the Insurance Securitization Working Group of the Financial Condition (E) Committee in 1999. The Emerging Accounting Issues Working Group adopted the guidance as “NAIC Preferred Accounting Treatment” in October 1999. This issue is specifically scoped out of FAS 133, and therefore the protected cell concept is unique to statutory accounting.
Relevant Statutory Accounting and GAAP Guidance

Statutory Accounting
24. In October 1999, the Emerging Accounting Issues Working Group adopted as “NAIC Preferred Accounting Treatment” the issue summary titled Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer through a Protected Cell. The guidance included in the Summary Conclusion section of this issue paper is consistent with the previously adopted issue summary.

Generally Accepted Accounting Principles
25. The following language is included in FAS No. 133, Accounting for Derivative Instruments and Hedging Activities:

192. Example 26: Disaster Bond. A bond that pays a coupon above that of an otherwise comparable traditional bond; however, all or a substantial portion of the principal amount is subject to loss if a specified disaster experience occurs.

Scope Application: A disaster bond can be viewed as a fixed-rate bond combined with a conditional exchange contract (an option). The investor receives an additional coupon interest payment in return for giving the issuer an option indexed to industry loss experience on a specified disaster. Because the option contract is indexed to the specified disaster experience, it cannot be viewed as being clearly and closely related to an investment in a fixed-rate bond. Therefore, the embedded derivative should be separated from the host contract and accounted for by both parties pursuant to the provisions of this Statement.

However, if the “embedded derivative” entitles the holder of the option (that is, the issuer of the disaster bond) to be compensated only for changes in the value of specified assets or liabilities for which the holder is at risk (including the liability for insurance claims payable due to the specified disaster) as a result of an identified insurable event (refer to paragraph 10(c)(2)), a separate instrument with the same terms as the “embedded derivative” would not meet the Statement's definition of a derivative in paragraphs 6–11. In that circumstance, because the criterion in paragraph 12(c) would not be met, there is no embedded derivative to be separated from the host contract, and the disaster bond would not be subject to the requirements of this Statement. The investor is essentially providing a form of insurance or reinsurance coverage to the issuer.

26. This issue paper only contemplates transactions with an indemnity-based trigger, as such they would be excluded from FAS 133 and accounting for as reinsurance under FAS 113 – Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.

Other Sources
27. The Insurance Securitization Working Group developed the following Protected Cell Model Act. Details of considerations made in drafting this model act can be found in the minutes of the working group.

Protected Cell Company Model Act

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Section 1. Short Title

This Act may be cited as the “Protected Cell Company Act.”

Section 2. Purpose

This Act is adopted to provide a basis for the creation of protected cells by a domestic insurer as one means of accessing alternative sources of capital and achieving the benefits of insurance securitization. Investors in fully funded insurance securitization transactions provide funds that are available to pay the insurer’s insurance obligations or to repay the investors or both. The creation of protected cells is intended to be a means to achieve more efficiencies in conducting insurance securitizations.

Drafting Note: Under the terms of the typical debt instrument underlying an insurance securitization transaction, prepaid principal is repaid to the investor on a specified maturity date with interest, unless a trigger event occurs. The insurance securitization proceeds secure both the protected cell company’s insurance obligations if a trigger event occurs, as well as the protected cell company’s obligation to repay the insurance securitization investors if a trigger event does not occur. Insurance securitization transactions have been performed through alien companies in order to utilize efficiencies available to alien companies that are not currently available to domestic companies. This Act is adopted in order to create more efficiency in conducting insurance securitization, to allow domestic protected cell companies easier access to alternative sources of capital, and to promote the benefits of insurance securitization generally.

Section 3. Definitions

For the purposes of this Act, the following terms shall have the following meanings:

A. “Domestic insurer” means an insurer domiciled in the State of [insert state].

B. “Fully funded” means that, with respect to any exposure attributed to a protected cell, the fair value of the protected cell assets, on the date on which the insurance securitization is effected, equals or exceeds the maximum possible exposure attributable to the protected cell with respect to such exposures.

C. “General account” means the assets and liabilities of a protected cell company other than protected cell assets and protected cell liabilities.

D. “Indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered by its incurring a specified level of losses under its insurance or reinsurance contracts.

E. “Fair value” of an asset (or liability) means the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a
discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm’s-length transaction. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

F. “Non-indemnity trigger” means a transaction term by which relief of the issuer’s obligation to repay investors is triggered solely by some event or condition other than the individual protected cell company incurring a specified level of losses under its insurance or reinsurance contracts.

G. “Protected cell” means an identified pool of assets and liabilities of a protected cell company segregated and insulated by means of this Act from the remainder of the protected cell company’s assets and liabilities.

Drafting Note: This term is meant to reference identification of statutorily segregated assets and liabilities through the accounting function. By attributing certain assets and liabilities to a protected cell on the protected cell company’s books and records, and otherwise complying with the provisions of this Act, the protected cell company will receive statutory insulation of those assets and liabilities from the protected cell company’s other assets and liabilities not identified in the accounting records as attributable to the protected cell.

H. “Protected cell account” means a specifically identified bank or custodial account established by a protected cell company for the purpose of segregating the protected cell assets of one protected cell from the protected cell assets of other protected cells and from the assets of the protected cell company’s general account.

Drafting Note: This term is meant to reference a custodial account established to hold and invest protected cell assets, such that protected cell assets are also distinct and identifiable from the assets of the general account.

I. “Protected cell assets” means all assets, contract rights and general intangibles, identified with and attributable to a specific protected cell of a protected cell company.

J. “Protected cell company” means a domestic insurer that has one or more protected cells.

K. “Protected cell company insurance securitization” means the issuance of debt instruments, the proceeds from which support the exposures attributed to the protected cell, by a protected cell company where repayment of principal or interest, or both, to investors pursuant to the transaction terms is contingent upon the occurrence or nonoccurrence of an event with respect to which the protected
cell company is exposed to loss under insurance or reinsurance contracts it has issued.

L. “Protected cell liabilities” means all liabilities and other obligations identified with and attributable to a specific protected cell of a protected cell company.

Section 4. Establishment of Protected Cells

A. A protected cell company may establish one or more protected cells with the prior written approval of the commissioner of a plan of operation or amendments thereto submitted by the protected cell company with respect to each protected cell in connection with an insurance securitization. Upon the written approval of the commissioner of the plan of operation, which shall include, but not be limited to, the specific business objectives and investment guidelines of the protected cell, the protected cell company may, in accordance with the approved plan of operation, attribute to the protected cell insurance obligations with respect to its insurance business and obligations relating to the insurance securitization and assets to fund the obligations. A protected cell shall have its own distinct name or designation, which shall include the words “protected cell.” The protected cell company shall transfer all assets attributable to a protected cell to one or more separately established and identified protected cell accounts bearing the name or designation of that protected cell. Protected cell assets shall be held in the protected cell accounts for the purpose of satisfying the obligations of that protected cell.

Drafting Note: Insert the title of the chief insurance regulatory official wherever the term “commissioner” appears.

B. All attributions of assets and liabilities between a protected cell and the general account shall be in accordance with the plan of operation approved by the commissioner. No other attribution of assets or liabilities may be made by a protected cell company between the protected cell company’s general account and its protected cells. Any attribution of assets and liabilities between the general account and a protected cell, or from investors in the form of principal on a debt instrument issued by a protected cell company in connection with a protected cell company securitization shall be in cash or in readily marketable securities with established market values.

C. The creation of a protected cell does not create, in respect of that protected cell, a legal person separate from the protected cell company. Amounts attributed to a protected cell under this Act, including assets transferred to a protected cell account, are owned by the protected cell company and the protected cell company may not be, nor hold itself out to be, a trustee with respect to those protected cell assets of that protected cell account. Notwithstanding the foregoing, the protected cell company may allow for a security interest to attach to protected cell assets or a protected cell account when in favor of a creditor of the protected cell and otherwise allowed under applicable law.

D. This Act shall not be construed to prohibit the protected cell company from contracting with or arranging for an investment advisor, commodity trading advisor, or other third party to manage the protected cell assets of a protected cell, provided that all remuneration, expenses and other compensation of the third party advisor or manager are payable from the protected cell assets of that protected cell and not from the protected cell assets of other protected cells or the assets of the protected cell company’s general account.
E. (1) A protected cell company shall establish administrative and accounting procedures necessary to properly identify the one or more protected cells of the protected cell company and the protected cell assets and protected cell liabilities attributable to the protected cells. It shall be the duty of the directors of a protected cell company to:

(a) Keep protected cell assets and protected cell liabilities separate and separately identifiable from the assets and liabilities of the protected cell company’s general account and;

(b) Keep protected cell assets and protected cell liabilities attributable to one protected cell separate and separately identifiable from protected cell assets and protected cell liabilities attributable to other protected cells.

(2) Notwithstanding the foregoing, if this section is violated, the remedy of tracing shall be applicable to protected cell assets when commingled with protected cell assets of other protected cells or the assets of the protected cell company’s general account. The remedy of tracing shall not be construed as an exclusive remedy.

F. The protected cell company shall, when establishing a protected cell, attribute to the protected cell assets with a value at least equal to the reserves and other insurance liabilities attributed to that protected cell.

Section 5. Use and Operation of Protected Cells

A. The protected cell assets of a protected cell may not be charged with liabilities arising out of any other business the protected cell company may conduct. All contracts or other documentation reflecting protected cell liabilities shall clearly indicate that only the protected cell assets are available for the satisfaction of those protected cell liabilities.

B. The income, gains and losses, realized or unrealized, from protected cell assets and protected cell liabilities shall be credited to or charged against the protected cell without regard to other income, gains or losses of the protected cell company, including income, gains or losses of other protected cells. Amounts attributed to any protected cell and accumulations on the attributed amounts may be invested and reinvested without regard to any requirements or limitations of Section [insert reference applicable sections of the insurance code imposing limitations on insurance company investments] and the investments in a protected cell or cells shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the protected cell company.

C. Assets attributed to a protected cell shall be valued at their fair value on the date of valuation.

D. A protected cell company shall, in respect of any of its protected cells, engage in fully funded indemnity triggered insurance securitization to support in full the protected cell exposures attributable to that protected cell. A protected cell company insurance securitization that is non-indemnity triggered shall qualify as an insurance securitization under the terms of this Act only after the commissioner, in accordance with the authority granted under Section 9 of this Act, adopts regulations addressing the methods of funding of the portion of the risk that is not indemnity based, accounting, disclosure, risk based capital treatment, and assessing risks associated with such securitizations. A protected cell company insurance securitization that is not fully funded, whether indemnity triggered or non-indemnity triggered, is prohibited. Protected cell assets may be
used to pay interest or other consideration on any outstanding debt or other obligation attributable to that protected cell, and nothing in this subsection shall be construed or interpreted to prevent a protected cell company from entering into a swap agreement or other transaction for the account of the protected cell that has the effect of guaranteeing interest or other consideration.

E. In all protected cell company insurance securitizations, the contracts or other documentation effecting the transaction shall contain provisions identifying the protected cell to which the transaction will be attributed. In addition, the contracts or other documentation shall clearly disclose that the assets of that protected cell, and only those assets, are available to pay the obligations of that protected cell. Notwithstanding the foregoing, and subject to the provisions of this Act and any other applicable law or regulation, the failure to include such language in the contracts or other documentation shall not be used as the sole basis by creditors, reinsurers or other claimants to circumvent the provisions of this Act.

F. A protected cell company shall only be authorized to attribute to a protected cell account the insurance obligations relating to the protected cell company's general account. Under no circumstances shall a protected cell be authorized to issue insurance or reinsurance contracts directly to policyholders or reinsureds or have any obligation to the policyholders or reinsureds of the protected cell company's general account.

G. At the cessation of business of a protected cell in accordance with the plan approved by the commissioner, the protected cell company shall voluntarily close out the protected cell account.

Section 6. Reach of Creditors and Other Claimants

A. (1) Protected cell assets shall only be available to the creditors of the protected cell company that are creditors in respect to that protected cell and shall thereby be entitled, in conformity with the provisions of this Act, to have recourse to the protected cell assets attributable to that protected cell, and shall be absolutely protected from the creditors of the protected cell company that are not creditors in respect of that protected cell and who, accordingly, shall not be entitled to have recourse to the protected cell assets attributable to that protected cell. Creditors with respect to a protected cell shall not be entitled to have recourse against the protected cell assets of other protected cells or the assets of the protected cell company's general account.

(2) Protected cell assets shall only be available to creditors of a protected cell company after all protected cell liabilities have been extinguished or otherwise provided for in accordance with the plan of operation relating to that protected cell.

B. When an obligation of a protected cell company to a person arises from a transaction, or is otherwise imposed, in respect of a protected cell:

(1) That obligation of the protected cell company shall extend only to the protected cell assets attributable to that protected cell, and the person shall, with respect to that obligation, be entitled to have recourse only to the protected cell assets attributable to that protected cell; and

(2) That obligation of the protected cell company shall not extend to the protected cell assets of any other protected cell or the assets of the protected cell company's general account, and that person shall not, with
respect to that obligation, be entitled to have recourse to the protected cell assets of any other protected cell or the assets of the protected cell company’s general account.

C. When an obligation of a protected cell company relates solely to the general account, the obligation of the protected cell company shall extend only to, and that creditor shall, with respect to that obligation, be entitled to have recourse only to, the assets of the protected cell company’s general account.

D. The activities, assets, and obligations relating to a protected cell are not subject to the provisions of Section [insert applicable sections of the insurance code addressing life and health and property and casualty guaranty or insolvency funds], and neither a protected cell nor a protected cell company shall be assessed by or otherwise be required to contribute to any guaranty fund or guaranty association in this state with respect to the activities, assets, or obligations of a protected cell. Nothing in this subsection shall affect the activities or obligations of an insurer’s general account.

E. In no event shall the establishment of one or more protected cells alone constitute or be deemed to be a fraudulent conveyance, an intent by the protected cell company to defraud creditors, or the carrying out of business by the protected cell company for any other fraudulent purpose.

Section 7. Conservation, Rehabilitation or Liquidation of Protected Cell Companies

A. Notwithstanding any contrary provision in the insurance code of this state, the regulations promulgated under the insurance code of this state, or any other applicable law or regulation, upon any order of conservation, rehabilitation or liquidation of a protected cell company, the receiver shall be bound to deal with the protected cell company’s assets and liabilities, including protected cell assets and protected cell liabilities, in accordance with the requirements set forth in this Act.

B. With respect to amounts recoverable under a protected cell company insurance securitization, the amount recoverable by the receiver shall not be reduced or diminished as a result of the entry of an order of conservation, rehabilitation or liquidation with respect to the protected cell company notwithstanding any provisions to the contrary in the contracts or other documentation governing the protected cell company insurance securitization.

Drafting note: A number of states require a liquidator to cancel policies within a pre-specified time period in the event of a liquidation. While reviewing the Plan of Operation, commissioners should consider the termination provisions, if any, of the securitization instruments in the event of the cancellation of all of the insurance policies underlying the securitization in order to assess whether any portion of the risk premium relating to those underlying policies should equitably be returned to the estate of the general account.
Section 8. No Transaction of an Insurance Business

A protected cell company insurance securitization shall not be deemed to be an insurance or reinsurance contract. An investor in a protected cell company insurance securitization shall not, by sole means of this investment, be deemed to be transacting an insurance business in this state. The underwriters or selling agents (and their partners, directors, officers, members, managers, employees, agents, representatives and advisors) involved in a protected cell company insurance securitization shall not be deemed to be conducting an insurance or reinsurance agency, brokerage, intermediary, advisory or consulting business by virtue of their activities in connection therewith.

Section 9. Authority to Adopt Regulations

The commissioner may promulgate regulations necessary to effectuate the purposes of this Act.

Section 10. Effective Date

This Act shall become effective on [insert date].

RELEVANT LITERATURE

Statutory Accounting
- Emerging Accounting Issues Working Group Minutes 99-3

Generally Accepted Accounting Principles
- FAS 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts
- FAS 133, Accounting for Derivative Instruments and Hedging Activities

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources
- Protected Cell Model Act
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Statutory Issue Paper No. 104

Reinsurance Deposit Accounting - An Amendment to SSAP No. 62, Property and Casualty Reinsurance

STATUS
Finalized September 12, 2000

Type of Issue:
Property and Casualty

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principle No. 62—Property and Casualty Reinsurance (SSAP No. 62) prescribes the accounting treatment for reinsurance contracts that do not transfer both components of insurance risk (underwriting risk and timing risk). The requirements for Generally Accepted Accounting Principles (GAAP) are contained within American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk (SOP No. 98-7).

2. The purpose of this issue paper is to address the requirements of SOP 98-7 and amend the deposit accounting provisions of SSAP No. 62. In considering GAAP guidance as reflected in SOP 98-7, the purpose of this issue paper is to amend the deposit accounting provisions of SSAP No. 62 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Deposit Accounting

3. This issue paper supersedes paragraph 34 of SSAP No. 62. The following guidance shall be followed when reinsurance contracts do not transfer both components of insurance risk.

4. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

   a. At the outset of the reinsurance agreement, the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding company and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding company if (i) the assuming company is licensed, accredited or otherwise qualified in the ceding company’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding company which meet the requirements of paragraph 16 of Appendix A-785;

   b. At subsequent reporting dates, the amount of the deposit/liability should be adjusted by calculating the effective yield on the deposit agreement to reflect actual payments to date (receipts and disbursements should be recorded through the deposit/liability accounts) and expected future payments (as discussed below), with a corresponding credit or charge to interest income or interest expense;

   c. The calculation of the effective yield should use the estimated amount and timing of cash flows. If a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows.
The deposit should be adjusted to the amount that would have existed at the reporting date had the new effective yield been applied since the inception of the reinsurance agreement. Changes in the carrying amount of the deposit asset/liability resulting from changes in the effective yield shall be recorded as interest income or interest expense.

d. It shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the deposit liability shall be recorded as interest expense – by the assuming insurer. Conversely, the ceding insurer shall increase its deposit (asset) with an offsetting credit to interest income; and increase its outstanding loss liability with an offsetting charge to incurred losses;

e. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding company’s Statement of Financial Position, schedules, and exhibits;

f. The assuming company shall record net consideration to be returned to the ceding company as a liability.

(For an illustration of the provisions of paragraph 4 see Exhibit A)

Disclosures

5. The financial statements shall disclose the following with respect to reinsurance agreements that have been accounted for as deposits:

a. A description of the reinsurance agreements.

b. Any adjustment of the amounts initially recognized for expected recoveries. The individual components of the adjustment (e.g., interest accrual, change due to a change in estimated or actual cash flow) shall be disclosed separately.

DISCUSSION

6. Subsequent to the adoption of SSAP No. 62, the AICPA issued SOP 98-7. This SOP provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-term life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

7. This issue paper adopts, with modification, AICPA SOP 98-7 paragraphs 10 to 12 and 19 (subsection b only). The fundamental concepts of SSAP No. 62 are based upon the fact that unless a reinsurance contract contains a transfer of insurance risk, no underwriting credit shall be granted. The critical ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Insurance risk involves uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claims settlement expenses (underwriting risk) and (b) the timing of the receipt and payment of those cash flows (timing risk). SOP 98-7 paragraphs 10 to 12 requires the use of the interest method for contracts that transfer neither timing nor underwriting risk and contracts that only transfer timing risk. This issue paper adopts the interest method contained with those paragraphs, but modifies the SOP to require the interest method when the contract does not transfer one or both components of insurance risk.

8. The issue paper rejects AICPA SOP 98-7 paragraphs 13 to 17 and 19 (subsections a and c). This is due to the fact that the SOP allows entities to take underwriting credit for contracts that only transfer
significant underwriting risk. This is in direct conflict with the fundamental concept that reinsurance contracts must transfer insurance risk (both underwriting and timing risks).

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

9. SSAP No. 62 paragraph 34:

Deposit Accounting

34. To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement shall be accounted for and reported as deposits in the following manner:

a. At the outset of the reinsurance agreement the net consideration paid by the ceding entity (premiums less commissions or other allowances) shall be recorded as a deposit by the ceding entity and as a liability by the assuming entity. The deposit shall be reported as an admitted asset by the ceding entity if (i) the assuming entity is licensed, accredited or otherwise qualified in the ceding entity’s state of domicile as described in Appendix A-785 or (ii) there are funds held by or on behalf of the ceding entity as described in Appendix A-785;

b. Throughout the life of the agreement, receipts and disbursements shall be recorded through the deposit/liability accounts;

c. When individual case reserves are the basis for the deposit and the assuming entity pays in excess of the amount transferred by the ceding entity, the amount paid in excess of the deposit received shall be recognized as a loss by the assuming entity and as a gain by the ceding entity as Other Income in the statement of income;

d. When the agreement is completed, or when there is a loss payment in excess of the deposit, any difference between consideration and recoveries shall be recorded in the Other Income or Loss account as a loss to the reinsurer and as a gain in the Other Income or Loss account by the reinsured;

e. With regard to bulk reserves, (i.e., IBNR) it shall be assumed that any cash transactions for the settlement of losses will reduce the asset/liability accounts by the amount of the cash transferred. When the remaining losses are revalued upward, an increase in the liability shall be recorded as a loss recognized by the assuming entity. Conversely, the ceding entity shall increase its deposit (asset) and outstanding loss liability;

f. No deduction shall be made from the loss and loss adjustment expense reserves on the ceding entity’s balance sheet, schedules, and exhibits; and

g. The assuming entity shall record net consideration to be returned to the ceding entity as liabilities.

10. The Property Casualty Reinsurance Study Group of the Accounting Practices and Procedures (E) Task Force reviewed SOP 98-7 in detail. The Study Group adopted its position at its March 7, 1999 meeting. The conclusion of this issue paper is consistent with the Study Group’s recommendation. The applicable section of the minutes is included herein:

Michael Moriarty (N.Y.) opened the meeting by inviting Keith Bell (Travelers) to comment on his previously submitted proposal to revise statutory accounting guidance to permit accrual of interest income or expense related to funds held on deposit type transactions. Mr. Bell stated that the intent of the proposed revision was to make the statutory rules more consistent with
Generally Accepted Accounting Procedures (GAAP) treatment, by using the interest method to reflect the actual cash flows and to periodically adjust the implicit rate of interest.

Peter Medley (Wis.) raised a question regarding the interest rate to be used for this purpose. Frank Maffa (American Reinsurance Company) explained that reinsurance agreements which did not satisfy risk transfer requirements had to be accounted for as deposit-transactions, and suggested that it would be appropriate to recognize the interest income or expense associated with the funds on deposit in a timely manner over the life of the transaction. Mr. Moriarty commented that he saw no reason not to permit accrual of such amounts and asked Norris Clark (Calif.) to explain how the proposed revision would be implemented. Mr. Clark said that the proposal would go from the study group to the Accounting Practices and Procedures Task Force, which would presumably consider the proposal to be a codification maintenance item which need not be referred to the Emerging Accounting Issues Task Force before the proposal could be implemented as a revision to the pertinent language in Statement of Statutory Accounting Principles (SSAP) No. 62 and the corresponding section of the Accounting Practices and Procedures Manual for Property and Casualty Companies.

Thomas Burke (N.H.) moved to adopt the proposal and Mr. Clark seconded the motion which passed on a 4 to 1 vote of the study group members.

**Generally Accepted Accounting Principles**

11. AICPA SOP 98-7 paragraphs 9 to 20:

*Initial Measurement*

9. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*. The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of this SOP.

*Subsequent Measurement*

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

10. For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

11. The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.
12. Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs 13 through 15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

13. Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

14. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured’s income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer’s income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph 19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

15. For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

16. Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5, Accounting for Foreign Property and Liability Reinsurance. As a result, the guidance in SOP 92-5, regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

17. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified...
into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, Accounting Changes.

Disclosures

18. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

19. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

   a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred loses

   b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

   c. The amortization expense attributable to the expiration of coverage provided under the contract

20. This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity’s fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

RELEVANT LITERATURE

Statutory Accounting
- SSAP No. 62—Property and Casualty Reinsurance
- March 7, 1999 minutes of the P/C Reinsurance Study Group

Generally Accepted Accounting Principles
- American Institute of Certified Public Accountants (AICPA) Statement of Position No. 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That do not Transfer Insurance Risk

State Regulations
- No additional guidance obtained from state statutes or regulations.
Exhibit A
Illustration of a Reinsurance Contract That Is Accounted for as a Deposit using the Interest Method

Assumptions:
- Premium = $1,000 (assumes no commissions or allowances)
- Coverage Period = 1 year
- Initial expected recoveries = $225 per year (at end of year) for five years
- Initial Implicit rate = 4 percent*

*present value of $225 per year for five years at 4 percent = $1,000

At the end of Year 2, the timing of anticipated recoveries under the reinsurance contract changes. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year.

<table>
<thead>
<tr>
<th>Description</th>
<th>Interest Income</th>
<th>Cash Recoveries</th>
<th>Deposit Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial payment</td>
<td></td>
<td></td>
<td>$1,000</td>
</tr>
<tr>
<td>Year 1 (4%)</td>
<td>$ 40</td>
<td>(225)</td>
<td>$1,040</td>
</tr>
<tr>
<td>End of Year 1</td>
<td></td>
<td></td>
<td>$ 815</td>
</tr>
<tr>
<td>Year 2 (4 %)</td>
<td>$ 33</td>
<td>(200)</td>
<td>$ 848</td>
</tr>
<tr>
<td>End of Year 2</td>
<td></td>
<td></td>
<td>$ 648</td>
</tr>
<tr>
<td>Yield adjustment</td>
<td>(8)</td>
<td></td>
<td>$ 640</td>
</tr>
<tr>
<td>Year 3 (3.63 %)</td>
<td>$ 23</td>
<td>(175)</td>
<td>$ 663</td>
</tr>
<tr>
<td>End of Year 3</td>
<td></td>
<td></td>
<td>$ 488</td>
</tr>
<tr>
<td>Year 4 (3.63 %)</td>
<td>$ 18</td>
<td>(175)</td>
<td>$ 506</td>
</tr>
<tr>
<td>End of Year 4</td>
<td></td>
<td></td>
<td>$ 331</td>
</tr>
<tr>
<td>Year 5 (3.63 %)</td>
<td>$ 12</td>
<td>(175)</td>
<td>$ 343</td>
</tr>
<tr>
<td>End of Year 5</td>
<td></td>
<td></td>
<td>$ 168</td>
</tr>
<tr>
<td>Year 6 (3.63 %)</td>
<td>$ 7</td>
<td>(175)</td>
<td>$ 175</td>
</tr>
<tr>
<td>End of Year 6</td>
<td></td>
<td></td>
<td>$ 0</td>
</tr>
</tbody>
</table>

At the inception of the contract, the ceding insurer records a deposit asset of $1,000 and the assuming company, a $1,000 deposit liability. The asset is admitted providing the conditions for credit for reinsurance are met.

At subsequent reporting dates, the deposit asset is adjusted by calculating the effective yield on the reinsurance agreement to reflect actual payments to date and expected future payments with a corresponding credit to interest income by the ceding company and interest expense by the assuming company.

At the end of year two, it is determined that the expected cash flows will differ from previous estimates, resulting in a lower effective yield on the deposit asset. The deposit asset is adjusted to the amount that would have existed at the reporting date had the new effective yield been applied from the inception of the reinsurance agreement. The adjustment is charged to interest income, i.e., as a reduction of interest income. Interest income during the remaining term of the agreement is reduced accordingly (i.e., the yield is reduced from 4.0% to 3.63%).
Statutory Issue Paper No. 105

Reporting on the Costs of Start-Up Activities

STATUS
Finalized September 12, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. This issue paper addresses start-up costs. In practice, various terms are used to refer to start-up costs, such as preopening, preoperating, and organization costs. For purpose of this issue paper, these costs are referred to as start-up costs. Current statutory accounting guidance is provided in SSAP No. 17—Preoperating and Research and Development Costs (SSAP No. 17). American Institute of Certified Public Accountants (AICPA) Statement of Position 98-5, Reporting on the Costs of Start-Up Activities, (SOP 98-5) specifically addresses the reporting of start-up costs.

2. The purpose of this issue paper is to adopt SOP 98-5 with modification to add certain disclosure requirements, which is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. Cost of start-up activities, including organization costs, shall be expensed as incurred. Start-up activities are defined broadly as those one-time activities related to: (1) opening a new facility; (2) introducing a new product or service; (3) conducting business in a new territory; (4) conducting business with a new class of customer or beneficiary; (5) initiating a new process in an existing facility; or (6) commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).

4. Cost of start-up activities incurred in an accounting period shall be disclosed in the annual audited statutory financial report only.

DISCUSSION

5. This issue paper adopts SOP 98-5, which requires costs of start-up activities and organization costs to be expensed as incurred. This is consistent with SSAP No. 17 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy.

6. SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) defines an asset as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Although in some instances start-up and organization costs may appear to comply with the definition of an asset established by SSAP No. 4, it is not consistent with the “Conservatism” concept included in the Statement of Concepts to presume that it is “probable” that an entity in a start-up phase will generate future economic benefits. Start-up and organization costs, therefore, do not meet the definition of an asset for statutory accounting purposes and as such should be expensed as incurred. To expense rather than to capitalize such costs is also consistent with the Recognition concept included in the Statement of Concepts, which states that a reporting entity’s “ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.”
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
7. SSAP No. 17, paragraph 2 states:

Preoperating, including organization and start up costs, and research and development costs shall be expensed as incurred. Preoperating and research and development costs are incurred for such new projects as: (a) arranging operations for a new company (e.g., legal, actuarial and accounting costs associated with regulatory approval and licensing and issuance of stock); (b) establishing production, sales or service facilities at a new site; (c) changing operations or production significantly; or (d) developing and producing a new product, adopting a new process or offering a new service.

Generally Accepted Accounting Principles
8. SOP 98-5, paragraph 12 states:

Conclusions

Accounting for Start-Up Costs
.12 Costs of start-up activities, including organization costs, should be expensed as incurred.

Drafting Notes/Comments
- SOP 98-5 contains illustrations that provide examples. These illustrations should not be interpreted to be all-inclusive.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 17—Preoperating and Research and Development Costs
- SSAP No. 4—Assets and Nonadmitted Assets

Generally Accepted Accounting Principles
- AICPA Statement of Position 98-5, Reporting on the Costs of Start-Up Activities

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 106

Real Estate Sales – An Amendment to SSAP No. 40, Real Estate Investments

STATUS
Finalized September 12, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for Real Estate is provided in SSAP No. 40—Real Estate Investments (SSAP No. 40). SSAP No. 40 adopted FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), with modification to paragraph 9 to indicate that only letters of credit from institutions listed by the Securities Valuation Office shall be included in determining the buyer’s initial investment. Although FAS 66 states that it is applicable to all sales of real estate, it does not explicitly define real estate or identify the real estate transactions to which it is specifically applicable.

2. Paragraph 1 of FASB Statement No. 66, Accounting for Sales of Real Estate, states, “This Statement establishes standards for recognition of profit on all real estate sales transactions without regard to the nature of the seller’s business.” FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66 (FIN 43) clarifies that the phrase “all real estate sales” to include sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98 (EITF 00-13) adds guidance relative to the definition of integral equipment.

3. The purpose of this issue paper is to adopt FIN 43 and EITF 00-13 which is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. This issue paper supersedes paragraphs 16 and 17 of SSAP No. 40. The following guidance shall be followed when accounting for the sales of real estate.

5. Recognition of profit on sales of real estate investments shall be accounted for in accordance with FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), except as modified in paragraph 6 of this statement, FASB Emerging Issues Task Force No. 87-9, Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds (EITF 87-9), FASB Emerging Issues Task Force No. 87-29, Exchange of Real Estate Involving Boot (EITF 87-29), FASB Interpretation No. 43, Real Estate Sales an interpretation of FASB Statement No. 66 (FIN 43) and FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98. This issue paper applies to all sales of real estate including real estate with property improvements or integral equipment. The terms “property improvements” and “integral equipment” refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant costs, such as an office building. Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:
a. A sale is consummated;

b. The buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller’s receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

6. The calculation of the buyer’s initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer’s notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer’s initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

DISCUSSION

7. This issue paper adopts FIN 43, which clarifies that the phrase “all real estate sales” includes sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs. This is consistent with SSAP No. 40 and the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also adopts EITF 00-13 which clarifies use of the term “integral equipment”.

Drafting Notes/Comments

- Accounting for leases and sale-leaseback transactions involving real estate transactions are addressed in SSAP No. 22—Leases.
- Accounting for leasehold improvements is addressed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.
- Accounting for transfers and servicing of financial assets and extinguishments of liabilities is addressed in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

8. SSAP No. 40, paragraphs 16 and 17 state:

**Sale of Real Estate**

16. Recognition of profit on sales of real estate investments shall be accounted for in accordance with FASB Statement No. 66, *Accounting for Sales of Real Estate* (FAS 66), except as modified in paragraph 17 of this statement, FASB Emerging Issues Task Force No. 87-9, *Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds* (EITF 87-9), and FASB Emerging Issues Task Force No. 87-29, *Exchange of Real Estate Involving Boot* (EITF 87-29). Profit shall be recognized in full when real estate is sold, provided (a) the profit is determinable, that is, the collectibility of the sales price is reasonably assured or the amount that will not be collectible can be estimated, and (b) the earnings process is virtually complete, that is, the seller is not obliged to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be postponed. Profit shall not be recognized by the full accrual method until all of the following criteria are met:

a. A sale is consummated;
b. The buyer’s initial and continuing investments are adequate to demonstrate a commitment to pay for the property;

c. The seller’s receivable is not subject to future subordination; and

d. The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale and does not have a substantial continuing involvement with the property after the sale.

17. The calculation of the buyer’s initial investment specified in paragraph 9 of FAS 66 shall be modified to reflect that buyer’s notes must be supported by letters of credit from institutions that are listed by the Securities Valuation Office of the National Association of Insurance Commissioners as meeting credit standards to be included in determining the buyer’s initial investment. Any profit or loss is considered a realized gain or loss in the year of the sale in accordance with FAS 66.

Generally Accepted Accounting Principles

9. FIN 43 provides the following guidance:

INTERPRETATION

2. Statement 66 applies to all sales of real estate, including real estate with property improvements or integral equipment. The terms property improvements and integral equipment as they are used in this Interpretation refer to any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost. Examples include an office building, a manufacturing facility, a power plant, and a refinery.

3. The provisions of Statement 66 do not apply to transactions that involve the following:

   a. The sale of only property improvements or integral equipment without a concurrent (or contemplated) sale of the underlying land\(^1\)

\(\text{_______}\)

\(^1\) Except for sales of property improvements or integral equipment with the concurrent lease (whether explicit or implicit in the transaction) of the underlying land to the buyer. Those transactions should be accounted for in accordance with paragraphs 38 and 39 of Statement 66. In addition, sales of property improvements or integral equipment subject to an existing lease of the underlying land are also subject to the provisions of Statement 66.

   b. The sale of the stock or net assets of a subsidiary or a segment of a business if the assets of that subsidiary or that segment, as applicable, contain real estate, unless the transaction is, in substance, the sale of real estate

   c. The sale of securities that are accounted for in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*\(^2\)

\(\text{_______}\)

\(^2\) Sales of those types of securities are addressed by FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

   

4. In the first sentence of paragraph 38 of Statement 66, the phrase property improvements is interpreted to include both property improvements and integral improvements (to conform that paragraph to the scope clarification provided by this Interpretation).
10. EITF 00-13 provides the following guidance:

1. With the issuance of Interpretation 43, which concludes that sales of integral equipment are within the scope of Statement 66, determining whether equipment constitutes "integral equipment" has taken on increased importance as that determination now affects whether the detailed guidance in Statement 66 should be applied to a transfer of equipment. Further, the appropriateness of sales-type lease classification by lessors for leases involving equipment is also impacted by the determination of whether the equipment to be leased is "integral equipment." In addition, that determination is important for reaching a conclusion as to whether Statement 98, with its more stringent provisions, applies to a sale-leaseback transaction.

2. Integral equipment is defined in Interpretation 43 as "any physical structure or equipment attached to the real estate that cannot be removed and used separately without incurring significant cost." The authoritative pronouncements governing the accounting for leasing transactions and sales of real estate do not provide any guidance for interpreting the phrase "cannot be removed and used separately without incurring significant cost," and, as a result, there may be diversity in practice with respect to determining what constitutes "integral equipment" for the purpose of applying Statements 13, 66, and 98.

3. This issue is how the determination of whether equipment is integral equipment should be made.

EITF 00-13 DISCUSSION

4. The Task Force agreed that the phrase "cannot be removed and used separately without incurring significant cost" contains two distinct concepts: (a) the ability to remove the equipment without incurring significant cost and (b) the ability of a different entity to use the equipment at another location without significant diminution in utility or value. The Task Force reached a consensus that the determination of whether equipment is integral equipment should be based on the significance of the cost to remove the equipment from its existing location (which would include the cost of repairing damage done to the existing location as a result of the removal), combined with the decrease in the value of the equipment as a result of that removal. The Task Force agreed that, at a minimum, the decrease in the value of the equipment as a result of its removal is the estimated cost to ship and reinstall the equipment at a new site. The nature of the equipment, and the likely use of the equipment by other potential users, should be considered in determining whether any additional diminution in fair value exists beyond that associated with costs to ship and install the equipment.

5. When the combined total of both the cost to remove plus the decrease in value (for leasing transactions, the information used to estimate those costs and the decrease in value should be as of lease inception) exceeds 10 percent of the fair value of the equipment (installed) (for leasing transactions, at lease inception), the equipment is integral equipment.

6. Refer to Exhibit 00-13A for an example that illustrates the application of this consensus.

Exhibit 00-13A

ILLUSTRATION OF THE APPLICATION OF THE EITF CONSENSUS ON ISSUE 00-13

Company A leases equipment to Company B for use in a manufacturing facility. The fair value of the production equipment (installed) at lease inception is $1,075,000. The estimated cost to remove the equipment after installation (estimate is as of the beginning of the lease term) is $80,000, which includes $30,000 to repair damage to the existing location as a result of the removal. The estimated cost to ship and reinstall the equipment at a new site (estimated as of the beginning of the lease term) is $85,000. For this example, assume that the equipment would have the same fair value (installed) to the seller and a potential buyer. Therefore, there is no
diminution in fair value of the equipment beyond the discount a purchaser would presumably require to cover the cost to ship and reinstall the equipment.

In accordance with this consensus, Company A would assess whether or not the production equipment is integral equipment as follows: 

\[(\$80,000 + \$85,000) \div \$1,075,000 = 15.3\% \]

Because the cost of removal combined with the diminution in value exceeds 10 percent of the fair value (installed) of the production equipment, the cost to remove the equipment and use it separately is deemed to be significant. Therefore, the production equipment is integral equipment.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 40—Real Estate Investments

Generally Accepted Accounting Principles
- FASB Interpretation No. 43, Real Estate Sales, an interpretation of FASB Statement No. 66
- FASB Statement No. 66, Accounting for Sales of Real Estate
- FASB Emerging Issues Task Force 00-13, Determining Whether Equipment is “Integral Equipment” Subject to FASB Statements No. 66 and No. 98

State Regulations
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 107

Certain Health Care Receivables and Receivables Under Government Insured Plans

STATUS
Finalized August 8, 2001

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) provides the definition of admitted and nonadmitted assets.

2. Pharmaceutical rebates are arrangements between pharmaceutical companies and reporting entities in which the reporting entities receive rebates based upon the drug utilization of its subscribers at participating pharmacies. Reporting entities use different ways to record pharmacy rebates on their financial statements. These rebates are sometimes recorded as receivables by reporting entities using estimates based upon historical trends which should be adjusted to reflect significant variables involved in the calculation, such as number of prescriptions written/filled, type of drugs prescribed, use of generic vs. brand-name drugs, etc. In some cases, the reporting entity determines the amount of the rebate due based on the actual use of various prescription drugs during the accumulation period and then invoices the pharmaceutical company. In other cases, an affiliated or unaffiliated pharmacy benefits management company may determine the amount of the rebate based on a listing (of prescription drugs filled) prepared for the reporting entity’s review. The reporting entity will confirm the listing and the pharmaceutical rebate receivable. The pharmacy benefits management company will then collect the amount due from the pharmaceutical company for remittance to the reporting entity. Some reporting entities do not participate in rebate arrangements at all but receive similar benefits through contracted discounts on pharmaceutical purchases. Current statutory accounting guidance does not specifically address the admittance of pharmaceutical rebates.

3. Claim overpayments may occur as a result of several events, including but not limited to claim payments made in error to a provider. Reporting entities often establish receivables for claim overpayments. Claim overpayments may meet the conditions for the right of offset as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64). Since claim overpayments are not specifically identified as an admitted asset within the Accounting Practices and Procedures Manual effective January 1, 2001 they would be reported as nonadmitted.

4. A health entity may make loans or advances to large hospitals or other providers. Such loans or advances are supported by legally enforceable contracts and are generally entered into at the request of the provider. In many cases, loans or advances are paid monthly and are intended to represent one month of fee-for-service claims activity with the respective provider. At least for large hospitals with many sources of cash flow, an offset for these loans and advances exists in the reporting entity’s combined reported and unreported claims liability and claims reserve. Additionally, such loans and advances are generally reconciled quarterly against actual claim utilization (allowing for adequate run-out of such claims) pursuant to contractual terms. In such cases, the reconciled differences are settled and the advance payments for future months may be adjusted based upon the materiality of reconciled differences. Current statutory guidance in SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25) is limited to loans and advances to related parties.
5. The glossary to the statements of statutory accounting principles contained in the Accounting Practices and Procedures Manual effective January 1, 2001, defines a capitation arrangement as a compensation plan used in connection with some managed care contracts in which a physician or other medical provider is paid a flat amount, usually on a monthly basis, for each subscriber who has elected to use that physician or medical provider. Risk sharing agreements are contracts between reporting entities and providers with a risk sharing element based upon utilization. The compensation payments for risk sharing agreements are typically estimated monthly and settled annually. These agreements can result in receivables due from the providers if annual utilization is different than that used in estimating the monthly compensation. SSAP No. 25 provides accounting guidance for loans and advances and advances under capitation arrangements to providers who meet the definition of related parties.

6. Current GAAP provides guidance relative to defining a health care receivable and accounting guidance on loan impairment. Such guidance is presented in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide: Health Care Organizations. This audit guide was rejected in SSAP No. 73—Health Care Delivery Assets – Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities.

7. SSAP No. 47—Uninsured Plans (SSAP No. 47) paragraph 10 c. provides accounting guidance for the admissibility of uninsured Medicare and similar government funded plans. Current statutory accounting guidance does not specifically address the admittance of amounts receivable under government insured plans.

8. The purpose of this issue paper is to establish statutory accounting principles for pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers who do not meet the definition of related parties, capitation arrangement receivables, risk sharing receivables, and amounts receivable under government insured plans consistent with the Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

9. The definition and accounting treatment for nonadmitted assets is outlined in paragraph 3 of SSAP No. 4 as follows:

As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet", and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity’s capitalization policy, immaterial amounts of furniture, fixtures, equipment, or supplies, can be expensed when purchased.
10. Pharmaceutical rebate receivables, claim overpayment receivables, loans and advances to providers, capitation arrangement receivables, risk sharing receivables, and amounts receivable under government insured plans meet the definition of assets as set forth in SSAP No. 4, and are admitted assets to the extent that the requirements for admission defined in this issue paper are met.

11. This issue paper shall not be considered an all-inclusive list of health care receivables. Certain health care receivables are addressed in other statements. Health care receivable assets not addressed in other statements or this statement are nonadmitted assets.

**Pharmaceutical Rebate Receivables**

12. Pharmaceutical rebate receivables consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Estimated amounts shall be related solely to actual prescriptions filled during the 3 months immediately preceding the reporting date;

b. Billed amounts represent pharmaceutical rebate receivables that have been invoiced or confirmed in writing but not collected as of the reporting date. Billed amounts for an estimated amount under paragraph 12 a. above shall be admitted only if the determination of the rebate, based on actual prescriptions filled, occurs and is invoiced or confirmed in writing within the 2 months following the reporting date of the estimated amount. Adjustments to previously billed amounts related to prior periods shall be nonadmitted until invoiced or confirmed in writing. Pharmaceutical rebates that have not been collected within 90 days of the invoice date or confirmation date shall be nonadmitted. Furthermore, if accrued pharmaceutical rebate receivables are not invoiced or confirmed in writing in accordance with the contract provisions, the accrual shall be nonadmitted; and

c. Evaluation of the collectibility of pharmaceutical rebate receivables shall be made periodically. If in accordance with **SSAP No. 5—Liabilities, Contingencies and Impairments of Assets** (SSAP No. 5), it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

13. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying pharmaceutical rebate contract provisions. The financial statements shall disclose information regarding the reporting entity’s pharmaceutical rebates in accordance with paragraph 26 of this issue paper.

14. Income from pharmaceutical rebates of insured plans shall be reported as a reduction to claims expense on the summary of operations.

15. Receivable and payable balances related to uncollected pharmaceutical rebates of uninsured plans shall be recorded on the financial statements of the reporting entity. Any pharmaceutical rebates earned by the reporting entity that are in excess of the amounts to be remitted to the uninsured plan pursuant to an administrative services agreement shall be determined consistent with the requirements of paragraphs 12 and 13 and shall be reported on the balance sheet as an amount receivable relating to uninsured accident and health plans, and as a reduction to general expenses on the statement of operations.

**Claim Overpayment Receivables**

16. A claim overpayment shall not be recorded as a receivable until invoiced. To the extent that the claim overpayment meets the setoff conditions in SSAP No. 64 and the overpayment is a specific...
identifiable payment and not an estimate, the receivable may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims). The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of claim overpayment receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Loans and Advances to Providers
17. Loans or advances to providers who meet the definition of related parties in SSAP No. 25 shall follow the guidance in that statement. To the extent a loan or advance to a non-related party provider meets the setoff conditions in SSAP No. 64, the loan or advance may be admitted up to the amount of the payable to the provider for reported claims (i.e., excluding incurred but not reported claims).

18. In addition, a loan or advance to a non-related party hospital shall be admitted up to the amount of claims incurred and payable to the hospital, if all of the following conditions are met:
   a. The loan or advance meets the setoff conditions in SSAP No. 64;
   b. The loan or advance is supported by a legally enforceable contract;
   c. The loan or advance is administered pursuant to contractual terms;
   d. The contractual terms of the agreement provide for separate quarterly reconciliations;
   e. Each quarterly reconciliation shall be completed within nine months of the end of such quarter; and
   f. A quarterly reconciled difference shall be settled within 90 days of the date the reconciliation is completed.

19. If a quarterly reconciliation is not performed or settled in accordance with paragraphs 18 e. and 18 f. above, all assets for loans or advances to that hospital shall be nonadmitted.

20. The receivable and payable shall be reported gross rather than netted on the balance sheet. Evaluation of the collectibility of loans and advances to providers shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made. Amounts in excess of that written off that do not meet the right of offset conditions shall be nonadmitted as they are not available to satisfy policyholder obligations.

Capitation Arrangement Receivables
21. Advances to providers under capitation arrangements that are made under the terms of an approved provider services contract in anticipation of future services shall be admitted to the extent that the advanced amount does not exceed one month of average capitation payments for the subject provider during the preceding twelve months, and provided that the contract cannot be terminated before the end of the month for which the advanced amount was paid. Evaluation of the collectibility of capitation arrangement receivables shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
Risk Sharing Receivables
22. Risk sharing receivables may consist of reasonably estimated amounts and billed amounts. Both the billed amount and the estimated amount shall be admitted assets subject to the conditions specified below:

a. Risk sharing receivables and payables shall only be recorded when reasonably estimated. Estimates of risk sharing receivables may be admitted if based on at least six months of actual claims experience for each risk sharing contract. The contractual terms of any risk sharing agreement shall provide for evaluation of the experience under the contract at least annually. The determination of the risk sharing balance shall commence no later than 6 months following the close of such annual period, and the balance shall be invoiced no later than 8 months following close of the annual period;

b. Billed amounts represent risk sharing receivables that have been invoiced but not collected as of the reporting date. Risk sharing receivables and payables shall be invoiced or refunded in accordance with the contractual provisions of the risk sharing agreement. Adjustments resulting in increases to previously billed amounts related to prior periods shall be nonadmitted until invoiced. Adjustments resulting in decreases to previously billed amounts shall be recognized immediately. Risk sharing receivables that have not been collected within 90 days of the date of invoicing shall be nonadmitted;

c. Risk sharing receivables and payables shall be reported gross rather than netted on the balance sheet. However, if a reporting entity has both a receivable and payable balance with the same provider and the balances meet the setoff conditions in SSAP No. 64, those balances shall be netted in accordance with SSAP No. 64; and

d. Evaluation of the collectibility of risk sharing receivables shall be made quarterly. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

23. The method used to reasonably estimate the receivable shall be consistent from period to period and shall be adjusted periodically for any changes in the underlying risk sharing contract. The financial statements shall disclose information regarding the reporting entity’s risk sharing receivables in accordance with paragraph 27 of this issue paper.

24. Income/expense from risk sharing contracts shall be reported as a component of claims expense on the summary of operations.

Amounts Receivable Under Government Insured Plans
25. Amounts receivable under government insured plans, including amounts over 90 days due, that qualify as accident and health contracts in accordance with SSAP No. 50—Classifications and Definitions of Insurance or Managed Care Contracts in Force shall be admitted assets. Amounts receivable under government insured plans include but are not limited to receivables under Medicare, Medicaid and similarly funded government insured plans. Evaluation of the collectibility of amounts receivable under government insured plans shall be made periodically. If in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.
Disclosures

26. The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following:

   a. Estimated balance of pharmacy rebate receivables as reported on the financial statements;
   b. Pharmacy rebates as invoiced or confirmed in writing; and
   c. Pharmacy rebates collected.

   An example of this disclosure is shown in Exhibit A to this issue paper.

27. The financial statements shall disclose the method used by the reporting entity to estimate its risk sharing receivables. If any receivable and payable balances with the same provider are netted, the reporting entity shall disclose the gross receivable and payable balances in the notes to the financial statements. Furthermore, for the most recent three years, the reporting entity shall also disclose the following:

   a. Risk sharing receivables as estimated and reported on the prior year financial statements for annual periods ending in the current year;
   b. Risk sharing receivables as estimated and reported on the financial statements for annual periods ending in the current year and the following year;
   c. Risk sharing receivables invoiced as determined after the annual period;
   d. Risk sharing receivables not yet invoiced; and
   e. Amounts collected from providers as payments under risk sharing contracts.

   An example of this disclosure is shown in Exhibit B to this issue paper.

Effective Date and Transition

28. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2001.

29. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 12 and shall invoice pharmaceutical rebates on no less than a semi-annual basis. Furthermore, prior to January 1, 2003, reporting entities may transition the 90 day admissibility provision outlined in paragraph 12 and shall nonadmit pharmaceutical rebates if such rebates have not been collected within 180 days of the invoicing date.

30. Prior to January 1, 2003, reporting entities may transition the invoicing provision outlined in paragraph 22 and shall invoice the risk sharing balance no later than 11 months days following the close of the annual period.

DISCUSSION

31. The statutory accounting principles outlined above are consistent with the conservatism and recognition concepts in the Statement of Concepts, current statutory accounting guidance and SSAP No. 4.
Conservatism

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

Recognition

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

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

32. SSAP No. 47 paragraph 8 provides guidance on accounting for amounts receivable from uninsured plans:

8. Amounts receivable from uninsured plans for (a) claims and other costs paid by the administrator on behalf of the third party at risk and (b) fees related to services provided by the administrator to the plan meet the definition of assets as set forth in SSAP No. 4—Assets and Nonadmitted Assets. A receivable shall not be recorded for unpaid claims. A receivable related to Medicare or a similarly structured cost based reimbursement contract shall only be recorded when services have been rendered.

33. SSAP No. 47 paragraph 10 c. provides guidance on determining the nonadmitted portion of amounts receivable from Medicare and similar government funded uninsured plans:

10 c. Medicare and similar government funded plans—Amounts due related to Medicare and similar government plans shall not be nonadmitted when they become over ninety days due. Appropriate reserves shall be established to cover costs incurred which may not be reimbursed upon final determination by the governing agencies under the cost contract or for adjustments to revenues based on performance under the terms of the contract or other external factors.

34. SSAP No. 64 paragraph 2 provides guidance on accounting for offsetting and netting of assets and liabilities:

2. Assets and liabilities shall be offset and reported net only when a valid right of setoff exists except as provided for in paragraphs 3 and 4. A right of setoff is a reporting entity's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying an amount that the other party owes to the reporting entity against the debt. A valid right of setoff exists only when all the following conditions are met:

a. Each of the two parties owes the other determinable amounts. An amount shall be considered determinable for purposes of this provision when it is reliably estimable by both parties to the agreement;

b. The reporting party has the right to setoff the amount owed with the amount owed by the other party;

c. The reporting party intends to setoff; and

d. The right of setoff is enforceable at law.
35. SSAP No. 25 paragraphs 7 and 8 include the following guidance for loans or advances by a reporting entity:

7. Loans or advances by a reporting entity to all other related parties shall be evaluated by management and nonadmitted if they do not constitute arm’s-length transactions as defined in paragraph 10. Loans or advances made by a reporting entity to related parties (other than its parent or principal owner) that are economic transactions as defined in paragraph 10 shall be admitted. This includes financing arrangements with providers of health care services with whom the reporting entity contracts with from time to time. Such arrangements can include both loans and advances to these providers. Evaluation of the collectibility of loans or advances shall be made periodically. If, in accordance with SSAP No. 5, it is probable the balance is uncollectible, any uncollectible receivable shall be written off and charged to income in the period the determination is made.

8. Any advances under capitation arrangements made directly to providers, or to intermediaries that represent providers, that exceed one month’s payment shall be nonadmitted assets.

Generally Accepted Accounting Principles
36. The AICPA Audit and Accounting Guide: Health Care Organizations states the following:

5.01. Receivables may include amounts due for (a) health care services from patients, residents, third-party payors, and employers; (b) premiums and stop-loss insurance recoveries; (c) intercompany transactions; (d) promises to give in future periods (pledges); and (e) amounts due from employees, physicians, or others. All loans, such as loans to physicians, should be evaluated periodically for impairment. Loans that are included in the scope of FASB Statement No. 114, Accounting by Creditors for Impairments of a Loan, should be evaluated based on the provisions of that statement. A loan is impaired when, based on current information and events, it is probable that the provider will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the loan agreement. If the provider measures an impaired loan using a present value amount, the creditor should calculate that present value based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan’s effective interest rate.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 4—Assets and Nonadmitted Assets
- SSAP No. 5—Liabilities, Contingencies and Impairment of Assets
- SSAP No. 20—Nonadmitted Assets
- SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
- SSAP No. 47—Uninsured Plans
- SSAP No. 64—Offsetting and Netting of Assets and Liabilities

Generally Accepted Accounting Principles
- The AICPA Audit and Accounting Guide: Health Care Organizations

State Regulations
- No additional guidance obtained from state statutes or regulations
### ISSUE PAPER NO. 107 – EXHIBIT A – ILLUSTRATION OF PHARMACEUTICAL REBATE RECEIVABLES

(000 omitted)

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<th>Quarter</th>
<th>Estimated Pharmacy Rebates as Reported on Financial Statements</th>
<th>Pharmacy Rebates as Invoiced/Confirmed</th>
<th>Actual Rebates Collected Within 90 Days of Invoicing/Confirmation</th>
<th>Actual Rebates Collected Within 91 to 180 Days of Invoicing/Confirmation</th>
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### ISSUE PAPER NO. 107 – EXHIBIT B – ILLUSTRATION OF RISK SHARING RECEIVABLES

(000 omitted)

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<th>Evaluation Period Year Ending</th>
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<th>Risk Sharing Receivable as Estimated and Reported in the Current Year</th>
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**DRAFTING NOTE:** If there were only one contract or if all contracts have the same experience period, then there would only be an entry in either the “Invoiced” or “Not Invoiced” column for the current year. This example assumes varying dates on experience periods for multiple contracts. Assumptions: Two risk sharing contracts are in place, one with an experience period that ends 3/31/03 and one with an experience period that ends 10/31/03.

The $155,000 receivable for the contract period that ends 3/31/03 would be invoiced no later than 11/30/03 (or 8 months days following close of the contract period) and could be received no later than 2/28/04. Therefore, the $155,000 would appear in the “Invoiced” column in 2003 but not shown as received in 2003. Further, the $189,000 estimate for the experience period that ends 3/31/04 could be recorded on the December 31, 2003 financial statement, since there is more than six months of experience under the contract.

The contract with the experience period that ends 10/31/03 with an estimated $77,000 receivable would be invoiced by 6/30/04 and received by 09/30/04. Therefore, it would appear in the “Not Invoiced” column and not shown as received in 2003. However, no estimate could be reported on the December 31, 2003 financial statement for the experience period that ends 10/31/04, because there is less than six months of experience under the contract.
Multiple Peril Crop Insurance

SUMMARY OF ISSUE

1. Farming has always been an inherently risky enterprise because farmers operate at the mercy of nature and frequently are subjected to weather-related perils such as droughts, floods, hurricanes, and other natural disasters. Since the 1930s, many farmers have been able to transfer part of the risk of loss in production to the federal government through the subsidized Multiple Peril Crop Insurance (MPCI) program administered by the Federal Crop Insurance Corporation (FCIC), an agency of the United States Department of Agriculture. Major legislation enacted in 1980 and 1994 restructured the MPCI program. The 1980 legislation enlisted, for the first time, private insurance companies to sell, service, and share the risk of MPCI insurance policies. Subsequently, in 1994, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act revised the program to offer farmers two primary levels of insurance coverage, catastrophic and buy-up.

2. Catastrophic insurance is designed to provide farmers with protection against extreme crop losses for a small processing fee. Buy-up insurance provides protection against more typical and smaller crop losses in exchange for a policyholder-paid premium. The government subsidizes the total premium for catastrophic insurance and a portion of the premium for buy-up insurance. Farmers who purchase buy-up crop insurance must choose both the coverage level (the proportion of the crop to be insured) and the unit price (such as, per bushel) at which any loss is calculated. With respect to the coverage level of production, farmers can choose to insure as much as 85 percent of normal production or as little as 50 percent of normal production at different price levels. With respect to the unit price, farmers choose whether to value their insured production at FCIC's full estimated market price or at a percentage of the full price.

3. In recent years, FCIC has introduced a new risk management tool called revenue insurance. Unlike traditional crop insurance, which insures against losses in the level of crop production, revenue insurance plans insure against losses in revenue. The plans protect the farmer from the effects of declines in crop prices or declines in crop yields, or both. Like traditional buy-up insurance, the government subsidizes a portion of the premiums. One of the plans, called Crop Revenue Coverage, is available in many states for major crops. Two other plans, called Income Protection and Revenue Assurance, are available to farmers in only limited areas.

4. Companies participate in the MPCI program with FCIC through the Standard Reinsurance Agreement (SRA) per the terms of which the insurance companies share in the underwriting results of each policy. In 1999, MPCI gross written premium was $2.3 billion and total insurance in force amounted to over $30.9 billion. The program has unique loss exposure characteristics, which resulted in a gross loss ratio over 200% for 1988 and 1993.

5. The SRA reinsurance terms provide a company the flexibility to limit its exposure on a state by state basis. MPCI premium is not expense loaded, therefore FCIC pays the insurance companies, on behalf of the policyholder, a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims.
6. The FCIC utilizes an escrow account to distribute or collect additional funds. Premium (collected from the policyholders and the federal government subsidy) is deposited in the escrow account and is available to pay the claims arising under the program.

7. Existing statutory accounting practices do not address the distinctive characteristics of the MPCI line of business. Current practices within the industry vary. Accordingly, this issue paper establishes statutory accounting principles for direct MPCI premium written and the related business ceded to FCIC, and is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. This issue paper also establishes statutory accounting principles for the recently enacted Aquatic Crop Reinsurance Agreement (hereinafter included in the term MPCI).

8. Commercial multiple-peril crop reinsurance and crop hail insurance would not be impacted by this issue paper and would continue to follow existing statutory accounting principles.

**SUMMARY CONCLUSION**

**Premium Recognition**

9. MPCI gross premium is defined as the contractually determined amount specified by FCIC to the policyholder for the effective period of the contract based on the actuarially determined expectation of risk and policy benefits associated with the coverage provided by the terms of the insurance contract. In addition, gross premium shall also include the government premium subsidy paid on behalf of the policyholder.

10. MPCI ceded premium and losses are defined as the amount calculated by applying the proportional and non-proportional factors as stated in the SRA. An example of this application is shown in Exhibit A to this issue paper.

11. MPCI written premium shall be recorded as soon as an estimate can be made, but no later than the processing date. Upon recording written premium, a liability for the unearned premium reserve shall be established to reflect the amount of premium for the portion of the insurance coverage that has not yet expired. Premiums shall be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

12. The company shall disclose the method used to compute the unearned premium reserve in the financial statements.

**Amounts Receivable or Payable**

13. The company shares underwriting risk with FCIC and can earn or lose money according to the claims it must pay farmers for crop losses. The company earns underwriting profits when the net retained premiums exceed the net crop loss claims paid. The company incurs underwriting losses when the net claims paid for crop losses exceed the net retained premiums. These definitions do not consider underwriting expenses, which would be included for traditional statutory accounting underwriting gains and losses. The use of the terms underwriting gains and losses in this issue paper are unique to the MPCI program. As the premiums of the program are held by FCIC in escrow, the company shall recognize as a write-in asset a receivable from FCIC for the amount of the underwriting gain (as defined in this paragraph). Whereas, when the company is in an underwriting loss position, the company shall recognize a write-in liability to the FCIC for the amount of the underwriting loss (as defined in this paragraph), as the monies held in the escrow account are not sufficient to cover the company’s claims. In accordance with the SRA, funds that remain in escrow will be distributed to the company at the conclusion of the contract period if the contract results in a gain to the company. If the company owes additional funds to the escrow (i.e., it is in a loss position), those funds are remitted on a periodic basis until the contract expires. These amounts shall be recorded net as the program meets the requirements of offsetting as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64). In accordance with SSAP No. 21—Other Admitted Assets (SSAP No. 21), the amount receivable under the Federal Crop Insurance program shall be reported as an admitted asset.
14. Amounts receivable from policyholders meet the definition of an admitted asset as set forth in SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) and should be accounted for in accordance with SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6). The due date shall be governed by contractual due date of the premium billing, and not the effective date of the contract.

Unpaid Losses and Loss Adjustment Expenses
15. In accordance with SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (SSAP No. 55), losses and loss adjustment expenses shall be recognized as expense when a covered or insured event occurs.

16. The covered or insured event is the occurrence of an incident which gives rise to a claim or the incurring of costs. Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event, it is necessary to establish a liability. The following are the types of future costs relating to the MPCI program:

a. Reported Losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the insurer as of the statement date;

b. Incurred But Not Reported Losses, (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the insurer as of the statement date;

c. Loss Adjustment Expenses: Costs expected to be incurred in connection with the adjustment and recording of losses defined in subparagraphs 16a. and 16b. of this issue paper.

Administrative Expense Payment
17. FCIC pays the insurance companies a percent of premium for administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The expense payment associated with the catastrophic coverage shall be recorded as a reduction of loss expenses whereas the expense payment for the buy-up coverage shall be recorded as a reduction of other underwriting expenses. The company shall disclose the total amounts received for each type of coverage.

Escrow Account
18. The escrow account shall not be recorded on the financial statements of the insurance company. This account is considered an FCIC account and as such is not owned by the insurance company, however, the company’s underwriting gain is reflected as a receivable in accordance with paragraph 13.

Effective Date
19. This issue paper is effective for SRA contracts entered into after January 1, 2001. A change resulting from the adoption of this issue paper shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Correction of Errors.

DISCUSSION
20. The conclusions reached in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy. The issue paper also relies on the conclusions reached in various other issue papers. Due to the unique terms and complicated provisions in the MPCI program and the SRA, there is very little specific guidance for insurers when accounting for MPCI premiums and losses.

21. The definition of gross premium is consistent with the contractual provisions of the MPCI program. The policyholder pays a portion of the buy-up coverage with the remainder subsidized by FCIC. As such it is consistent and reasonable to report both components as gross premium. The ceded premium is computed using the factors given in the SRA. The SRA is unlike traditional reinsurance agreements in that it includes both proportional and non-proportional coverage within the same agreement contingent upon underwriting
results. As such, it is essential that each company compute and report ceded premiums consistently. Exhibit A is included to provide an illustration of the computation. Written premium in this issue paper is accounted for differently than SSAP No. 53—Property Casualty Contracts - Premiums (SSAP No. 53). SSAP No. 53 states that written premium shall be recorded on the effective date of the contract whereas this issue paper states that written shall be recorded on the processing date. This difference is due to the fact that policyholders engage in the contracts before they know how much acreage will be covered under the contract. Once the crops have been planted, an acreage report is generated which is used to compute the premium due under the contract. Therefore, it would be unreasonable for the insurance company to record written premium on the effective date, as the premium is not yet determinable.

22. The amounts receivable or payable from FCIC are addressed in SSAP No. 21. SSAP No. 21 states that amounts receivable from Federal Crop Insurance programs shall be reported as admitted assets. The amount receivable from policyholders is addressed in SSAP No. 6. This issue paper clarifies that the due date of the receivable shall be governed by the contractual due date of the premium billing as the premiums are computed months after the contracts are effective. If the receivables were aged as of the effective date, they could be non-admitted before they billed.

23. Unpaid losses and loss adjustment expenses shall be recorded consistent with SSAP No. 55. The conclusions reached in SSAP No. 55 are consistent with the provisions of the MPCI program.

24. FCIC pays the insurance companies a percent of premium for the administrative expenses associated with selling and servicing crop insurance policies, including the expenses associated with adjusting claims. The requirement to show these payments as reductions in loss adjustment expenses and other underwriting expenses is because the MPCI premium is not expense loaded. Some companies simply pass these payments to the agents in lieu of commissions. In that case, the remittance would then also be recorded as an increase in other underwriting expenses (i.e., commission expense) and there would be no effect on net income.

Drafting Notes/Comments
25. Companies writing MPCI as their predominate line of insurance can experience distorted Insurance Regulatory Information System (IRIS) ratios based upon the accounting for this line of business. The acceptable ranges for the IRIS ratios should either be changed or the ratios should be footnoted by NAIC based upon the uniqueness on the MPCI line of insurance. The IRIS ratios most often affected are gross premiums to surplus, agent’s balances to surplus, and liabilities to liquid assets.


RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
Statutory literature does not specifically address the MPCI program.

Generally Accepted Accounting Principles
GAAP literature does not specifically address the MPCI program.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 3—Accounting Changes and Corrections or Errors
- SSAP No. 4—Definition of Assets and Nonadmitted Assets
- SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
- SSAP No. 21—Other Admitted Assets
- SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
- SSAP No. 62—Property and Casualty Reinsurance
- SSAP No. 64—Offsetting and Netting of Assets and Liabilities

**Generally Accepted Accounting Principles**
- No further guidance obtained from GAAP literature

**State Regulations**
- No further guidance obtained from state statutes or regulations

**Other Sources of Information**
- United States General Accounting Office Testimony Before the Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, March 17, 1999
- KPMG Peat Marwick Multi-Peril Crop Insurance Revenue Recognition Survey, December 18, 1996
**EXHIBIT A - ILLUSTRATION OF CEDED PREMIUMS AND LOSSES**

**NOTES TO THE ILLUSTRATION**

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund</td>
<td>The reinsurance fund specified in the Standard Reinsurance Agreement (SRA).</td>
</tr>
<tr>
<td>Column 1</td>
<td>Reinsured Company proportional reinsurance retention percentage.</td>
</tr>
<tr>
<td>Column 2</td>
<td>Gross Written Premium equals the insured paid premium amount plus premium subsidy provided by FCIC.</td>
</tr>
<tr>
<td>Column 3</td>
<td>Net Retained Premium is the Reinsured Company retained premium after proportional reinsurance. Gross Written Premium (Column 2) times the Reinsured Company retention percentage (Column 1).</td>
</tr>
<tr>
<td>Column 4</td>
<td>Proportional Ceded Premium is the premium retained by FCIC after proportional reinsurance. Gross Written Premium (Column 2) minus the Reinsured Company Net Retained Premium (Column 3).</td>
</tr>
<tr>
<td>Column 5</td>
<td>Reinsured Company proportional reinsurance retention percentage (Column 1).</td>
</tr>
<tr>
<td>Column 6</td>
<td>Gross Losses equals total claim payments to insured.</td>
</tr>
<tr>
<td>Column 7</td>
<td>Net Retained Losses are the Reinsured Company retained losses after proportional reinsurance. Gross Losses (Column 6) times the Reinsured Company retention percentage (Column 5).</td>
</tr>
<tr>
<td>Column 8</td>
<td>Proportional Ceded Losses are the losses retained by FCIC after proportional reinsurance. Gross Losses (Column 7) minus the Reinsured Company Net Retained Losses (Column 7).</td>
</tr>
<tr>
<td>Column 9</td>
<td>Retained Loss Ratio is the Reinsured Company's Net Retained Losses (Column 7) divided by the Reinsured Company's Net Retained Premium (Column 3).</td>
</tr>
<tr>
<td>Column 10</td>
<td>Underwriting (Gain)/Loss is the Reinsured Company share of the MPCI program gain or loss after calculating the non-proportional reinsurance provided in the SRA.</td>
</tr>
<tr>
<td>Column 11</td>
<td>Non-Proportional Ceded Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting (Gain) (Column 10) if one exists. This is FCIC’s share of the underwriting gain after proportional reinsurance, based on the non-proportional reinsurance gain sharing factors specified in the SRA.</td>
</tr>
<tr>
<td>Column 12</td>
<td>Non-Proportional Ceded Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus Net Retained Losses (Column 7) minus an Underwriting Loss (Column 10) if one exists. This is FCIC’s share of the underwriting loss after proportional reinsurance, based on the non-proportional reinsurance loss sharing factors specified in the SRA.</td>
</tr>
<tr>
<td>Column 13</td>
<td>Final Retained Premium is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Premium (Column 11). The Reinsured Company Net Retained Premium after proportional reinsurance is reduced by the amount of FCIC’s underwriting gain share after non-proportional reinsurance.</td>
</tr>
<tr>
<td>Column</td>
<td>Description</td>
</tr>
<tr>
<td>--------</td>
<td>-------------</td>
</tr>
<tr>
<td>14</td>
<td>Final Retained Losses is equal to the Reinsured Company Net Retained Premium (Column 3) minus the Non-Proportional Ceded Losses (Column 12). The Reinsured Company Net Retained Losses after proportional reinsurance are reduced by the amount of FCIC's underwriting loss share after non-proportional reinsurance.</td>
</tr>
</tbody>
</table>
| 15     | Final Retained Loss Ratio is equal to Final Retained Losses divided by Final Retained Premium.  

(a) Calculated based on the loss ratios for each fund by state. Net Retained Premium (Col 3) is applied to the percentages of Section II. C. and D. of the Standard Reinsurance Agreement.  

(b) If the fund is in a GAIN position then there would be Non-proportional ceded premium. If the fund is in a LOSS position then there would be Non-proportional ceded losses.  

Since each fund and state stands alone in the calculations, there is a possibility of Non-proportional ceded premium AND ceded losses within the same reinsurance year. There is also the possibility of this within the same fund (some states with a Gain and some states with a Loss).
## Exhibit A - Illustration of Ceded Premiums and Losses

<table>
<thead>
<tr>
<th>Fund</th>
<th>Retention</th>
<th>Gross Written Premium</th>
<th>Net Retained Premium</th>
<th>Proportional Ceded Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>20%</td>
<td>20,000,000</td>
<td>4,000,000</td>
<td>16,000,000</td>
</tr>
<tr>
<td>Developmental</td>
<td>35%</td>
<td>10,000,000</td>
<td>3,500,000</td>
<td>6,500,000</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>35%</td>
<td>5,000,000</td>
<td>1,750,000</td>
<td>3,250,000</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>35%</td>
<td>5,000,000</td>
<td>1,750,000</td>
<td>3,250,000</td>
</tr>
<tr>
<td>Commercial</td>
<td>100%</td>
<td>100,000,000</td>
<td>100,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>100%</td>
<td>20,000,000</td>
<td>20,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>100%</td>
<td>40,000,000</td>
<td>40,000,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Premium</strong></td>
<td></td>
<td><strong>200,000,000</strong></td>
<td><strong>171,000,000</strong></td>
<td><strong>29,000,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fund</th>
<th>Retention</th>
<th>Gross Losses</th>
<th>Net Retained Losses</th>
<th>Proportional Ceded Losses</th>
<th>Retained Loss Ratio</th>
<th>Underwriting (Gain)Loss (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>20%</td>
<td>40,000,000</td>
<td>8,000,000</td>
<td>32,000,000</td>
<td>200.0%</td>
<td>184,000</td>
</tr>
<tr>
<td>Developmental</td>
<td>35%</td>
<td>16,000,000</td>
<td>5,600,000</td>
<td>10,400,000</td>
<td>160.0%</td>
<td>525,000</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>35%</td>
<td>7,000,000</td>
<td>2,450,000</td>
<td>4,550,000</td>
<td>140.0%</td>
<td>210,000</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>35%</td>
<td>4,000,000</td>
<td>1,400,000</td>
<td>2,600,000</td>
<td>80.0%</td>
<td>(157,500)</td>
</tr>
<tr>
<td>Commercial</td>
<td>100%</td>
<td>80,000,000</td>
<td>80,000,000</td>
<td>0</td>
<td>80.0%</td>
<td>(18,800,000)</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>100%</td>
<td>18,000,000</td>
<td>18,000,000</td>
<td>0</td>
<td>90.0%</td>
<td>(1,880,000)</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>100%</td>
<td>22,000,000</td>
<td>22,000,000</td>
<td>0</td>
<td>55.0%</td>
<td>(12,500,000)</td>
</tr>
<tr>
<td><strong>Total Losses</strong></td>
<td></td>
<td><strong>187,000,000</strong></td>
<td><strong>137,450,000</strong></td>
<td><strong>49,550,000</strong></td>
<td><strong>80.4%</strong></td>
<td><strong>(32,418,500)</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Fund</th>
<th>Non-Proportional Ceded Premium (b)</th>
<th>Non-Proportional Ceded Losses (b)</th>
<th>Final Retained Premium (Col 3 - Col 11)</th>
<th>Final Retained Losses (Col 7 - Col 12)</th>
<th>Final Retained Loss Ratio (Col 14/Col 13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assigned Risk</td>
<td>0</td>
<td>3,816,000</td>
<td>4,000,000</td>
<td>4,184,000</td>
<td>104.6%</td>
</tr>
<tr>
<td>Developmental</td>
<td>0</td>
<td>1,575,000</td>
<td>3,500,000</td>
<td>4,025,000</td>
<td>115.0%</td>
</tr>
<tr>
<td>Dev - CRC</td>
<td>0</td>
<td>490,000</td>
<td>1,750,000</td>
<td>1,960,000</td>
<td>112.0%</td>
</tr>
<tr>
<td>Dev - CAT</td>
<td>192,500</td>
<td>0</td>
<td>1,557,500</td>
<td>1,400,000</td>
<td>89.9%</td>
</tr>
<tr>
<td>Commercial</td>
<td>1,200,000</td>
<td>0</td>
<td>98,800,000</td>
<td>80,000,000</td>
<td>81.0%</td>
</tr>
<tr>
<td>Comm - CRC</td>
<td>120,000</td>
<td>0</td>
<td>19,880,000</td>
<td>18,000,000</td>
<td>90.5%</td>
</tr>
<tr>
<td>Comm - CAT</td>
<td>5,500,000</td>
<td>0</td>
<td>34,500,000</td>
<td>22,000,000</td>
<td>63.8%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>7,012,500</td>
<td>5,881,000</td>
<td>163,987,500</td>
<td>131,569,000</td>
<td>80.2%</td>
</tr>
</tbody>
</table>
Statutory Issue Paper No. 109

Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

STATUS
Finalized September 12, 2000

Type of Issue:
Common

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principle No. 16—Electronic Data Processing Equipment and Software (SSAP No. 16) requires depreciation of all electronic data processing (EDP) equipment and software for a period not to exceed three years. This requirement is applicable to both operating and nonoperating system software.

2. The purpose of this issue paper is to amend SSAP No. 16 to allow the depreciation of nonoperating system software over the lesser of its useful life or five years rather than three years. The conclusions outlined in this issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

3. This issue paper amends paragraph 3 and 8 of SSAP No. 16. The following guidance shall be followed for depreciation of EDP equipment, operating system software and nonoperating system software.

4. EDP equipment and operating system software shall be depreciated over the lesser of its useful life or three years. Nonoperating system software shall be depreciated over the lesser of its useful life or five years. In either case, the methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements shall be used.

Effective Date

5. EDP equipment and operating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or three years. Nonoperating system software capitalized prior to January 1, 2001 shall be depreciated over the lesser of its remaining useful life or five years.

DISCUSSION

6. A different amortization period for nonoperating system software, often called “applications software,” was not discussed during the initial drafting of SSAP No. 16. The amortization period for admitted EDP and software was discussed as part of the overall debate about whether any or all EDP and operating systems software should be an admitted asset. Amortization of nonoperating system software over a five year period does not violate the Statement of Concepts as illustrated below:

   a. Allowing amortization of nonoperating system software over its useful life by an appropriate method requires an insurer to appropriately recognize the expense and its income effect over time;
b. The statutory accounting concept of conservatism is served by continuing to nonadmit nonoperating system software. It is not violated by allowing amortization over a longer period of time than three years if that period is no longer than the software's useful life; and

c. Implementation of SSAP No. 16 as drafted may adversely affect companies and regulators by requiring insurers to accelerate expense recognition in a manner that was not foreseen. A number of states allow amortization of admitted EDP equipment and software over periods as long as 10 years, and current statutory accounting (prior to implementation of SSAP No. 16) provides the option of amortizing nonoperating systems software over its useful life. In addition, the initial draft of Issue Paper No. 16 allowed depreciation of nonadmitted EDP and software against net income as the estimated economic benefit expired. In 1999 insurers made significant purchases of nonoperating system software, in many cases to ensure that the software was not subject to the “year 2000 problem.”

7. SSAP No. 16 currently requires EDP equipment and software capitalized prior to January 1, 2001 to be depreciated over the lesser of its remaining useful life or three years; therefore it is important that this issue paper be implemented concurrently with the effective date of SSAP No. 16.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. SSAP No. 16 paragraphs 3 and 8:

3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles
9. GAAP does not address the issue of different depreciation periods for operating and nonoperating system software.

Drafting Notes/Comments
- AICPA Statement of Position 98-1: Accounting for Costs of Computer Software Developed or Obtained for Internal Use will be addressed in a separate issue paper.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 16—Electronic Data Processing Equipment and Software
- SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
Statutory Issue Paper No. 110

Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51, *Life Contracts*, SSAP No. 52, *Deposit-Type Contracts*, and SSAP No. 56, *Separate Accounts*

**STATUS**
Finalized September 12, 2000

**Type of Issue:**
Life

**SUMMARY OF ISSUE**

1. *Statement of Statutory Accounting Principles No. 51—Life Contracts* (SSAP No. 51) prescribes the accounting treatment for life contracts, *SSAP No. 52—Deposit-Type Contracts* (SSAP No. 52) prescribes the accounting treatment for deposit-type contracts, and *SSAP No. 56—Separate Accounts* (SSAP No. 56) prescribes the accounting treatment for separate accounts.

2. The purpose of this issue paper is to amend SSAP No. 51, SSAP No. 52 and SSAP No. 56 to incorporate the guidance included in appendices A-200, A-695 and A-830 and remain consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

**SUMMARY CONCLUSION**

3. Statutory policy reserves for those group annuity contracts or other contracts that, in whole or in part, establish the insurer’s obligations by reference to a segregated portfolio of assets not owned by the insurer shall be established in accordance with the guidance in Appendix A-695.

4. Statutory policy reserves for those contracts with nonlevel premiums or benefits, or contracts with secondary guarantees shall be established in accordance with the guidance in Appendix A-830.

5. Statutory policy reserves for those group life contracts utilizing a separate account that meet the requirements outlined in paragraph 1 of Appendix A-200 shall be computed in accordance with the guidance in that appendix.

6. This issue paper amends paragraph 43 of SSAP No. 51 to the following:


7. This issue paper amends paragraph 19 of SSAP No. 52 to the following:


8. This issue paper amends the first sentence of paragraph 23 of SSAP No. 56 to the following:

9. This issue paper amends paragraph 30 of SSAP No. 56 to the following:


**Effective Date**

10. This issue paper is effective for years beginning January 1, 2001. Contracts issued prior to January 1, 2001 shall be accounted for based on the laws and regulations of the domiciliary state.

**DISCUSSION**

11. Subsequent to the NAIC’s adoption of SSAP No. 51, SSAP No. 52, and SSAP No. 56, the NAIC adopted the Separate Accounts Funding Guaranteed Minimum Benefits Under Group Contracts Model Regulation, the Synthetic Guaranteed Investment Contracts Model Regulation, and the Valuation of Life Insurance Policies Model Regulation. Appendices A-200, A-695 and A-830 excerpt the accounting guidance from each of these three model regulations, respectively. This issue paper incorporates the requirements of these appendices.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE**

**Statutory Accounting**

12. SSAP No. 51 paragraph 43:


13. SSAP No. 52, paragraph 19:


14. SSAP No. 56, paragraph 23:

23. The reserving methodologies and assumptions used in computation of policy reserves shall also meet the provisions of Appendices A-250, A-270, A-255, A-585, A-588, A-620, A-820, A-822, and the actuarial guidelines found in Appendix C of this Manual. Where separate account contracts have guaranteed elements, the basis for determining the value of the liability shall be consistent with the basis used for asset values (i.e., valuation interest rates as defined in Appendix A-820) shall be used when assets are recorded as if held in the general account and current interest rates based on market rates shall be used when assets are recorded at market). Further, policy reserves shall be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

15. SSAP No. 56, paragraph 30:


**RELEVANT LITERATURE**

**Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 50—*Classifications and Definitions of Insurance or Managed Care Contracts In Force*
- SSAP No. 51—*Life Contracts*
- SSAP No. 52—Deposit-Type Contracts
- SSAP No. 56—Separate Accounts

**Generally Accepted Accounting Principles**
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*
- AICPA Statement of Position 95-1, *Accounting for Certain Activities of Mutual Life Insurance Enterprises*
- FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises, an interpretation of FASB Statements No. 12, 60, 97, and 113*
- AICPA Practice Bulletin 8, *Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
- AICPA Audit and Accounting Guide: Stock Life Insurance Companies

**State Regulations**
- No additional guidance obtained from state statutes or regulations.
Statutory Issue Paper No. 111

Software Revenue Recognition

STATUS
Finalized December 4, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. During the development of the initial Statements of Statutory Accounting Principles (SSAP) issues related to software revenue recognition were deemed to be not applicable to statutory accounting. Since the development of the initial SSAPs, significant changes have occurred in the world of technology and the opportunities available to insurance entities to license, sell, lease or otherwise market computer software have greatly expanded.

2. Generally Accepted Accounting Principles (GAAP) guidance for software revenue recognition was originally addressed in Statement of Position (SOP) 91-1, Software Revenue Recognition. SOP 91-1 was published to provide guidance on applying GAAP to software transactions and to narrow the range of revenue recognition practices that were in use before its issuance. Since the distribution of SOP 91-1, practice issues have been identified that are not addressed adequately in SOP 91-1. Therefore, the American Institute of Certified Public Accountants (AICPA) issued SOP 97-2, Software Revenue Recognition to replace SOP 91-1. SOP 97-2 has been modified by the issuance of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition and SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions. SOP 97-2 has also been interpreted by the Emerging Issues Task Force (EITF) 00-3, Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware.

3. The purpose of this issue paper is to address SOP 97-2, SOP 98-4, SOP 98-9 and EITF 00-3 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 97-2 paragraphs 6 through 91 with certain modifications, SOP 98-9 paragraphs 6 through 8 and EITF 00-3. This issue paper rejects SOP 98-4 as not applicable because the effective date of the corresponding SSAP is expected to be January 1, 2002.

5. The modifications to SOP 97-2 are as follows:

a. Paragraph 10 is amended to require that entities follow the guidance outlined in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets rather than Statement of Financial Accounting Standard (FAS) No. 5, Accounting for Contingencies;

b. Paragraph 33 is amended to remove the reference to Technical Bulletin (TB) No. 79-10: Fiscal Funding Clauses in Lease Agreements;

c. Paragraph 57 is amended to remove the reference to FAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed;
d. Paragraph 73 is rejected as not applicable to statutory accounting.

Effective Date and Transition

6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

DISCUSSION:

7. The modifications to SOP 97-2 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.

a. Paragraph 10 is amended because it includes a reference to FAS No. 5, *Accounting for Contingencies*. SSAP No. 5 — *Liabilities, Contingencies and Impairments of Assets* contains the authoritative statutory accounting for loss contingencies;

b. Paragraph 33 is amended because it includes a reference to TB No. 79-10. The removal of the reference does not change the accounting prescribed in SOP 97-2 and it eliminates any possible conflict with the fact that TB No. 79-10 is rejected by SSAP No. 22 — *Leases*;

c. Paragraph 57 was amended because it includes a reference to FAS No. 86. Paragraph 57 is not impacted by the removal of FAS No. 86 because it is used in the context of a piece of historical evidence. SSAP No. 17 - *Preoperating and Research and Development Costs* requires all such costs to be expensed, therefore there is no capitalization experience to analyze;

d. Paragraph 73 was deemed to be not applicable because of the requirement to follow FAS No. 86 in the case of capitalizing software-development costs. This approach is inconsistent with the provisions of SSAP No. 17 and the requirement to expense such costs. The directive to expense such costs eliminates the need for this paragraph.

8. SOP 98-4 as well as the effective date paragraphs of SOP 97-2 and SOP 98-9 were not adopted in this issue paper as it is expected that the effective date for the SSAP will be January 1, 2002.

9. EITF 00-3 was adopted because it supports the principles adopted in SOP 97-2.

10. SOP 97-2 includes several references to GAAP pronouncements that were deemed not applicable in the initial SSAPs. This includes Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, FAS No. 48, *Revenue Recognition When Right of Return Exists* and FAS 68, *Research and Development Arrangements*. These GAAP pronouncements are deemed to be applicable to statutory accounting only to the extent that SOP 97-2 references them.
RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting
11. In general, the initial SSAPs deemed the relevant GAAP guidance to be not applicable to statutory accounting. As discussed above, technology and the environment have changed significantly since the original SSAPs were adopted and therefore guidance is now needed.

Generally Accepted Accounting Principles
12. AICPA Statement of Position 97-2, Software Revenue Recognition provides the following:

Conclusions

.06 The following conclusions should be read in conjunction with the Basis for Conclusions section, beginning with paragraph .93 of this SOP, and the examples in appendix A, Examples of the Application of Certain Provisions of this SOP.

Basic Principles

.07 Software arrangements range from those that provide a license for a single software product to those that, in addition to the delivery of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, Long-Term Construction-Type Contracts, using the relevant guidance herein, and in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

.08 If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.
   • Persuasive evidence of an arrangement exists.
   • Delivery has occurred.
   • The vendor’s fee is fixed or determinable.
   • Collectibility is probable.

.09 Software arrangements may provide licenses for multiple software deliverables (for example, software products, upgrades/enhancements, PCS, or services), which are termed multiple elements. A number of the elements may be described in the arrangement as being deliverable only on a when-and-if-available basis. When-and-if-available deliverables should be considered in determining whether an arrangement includes multiple elements. Accordingly, the requirements of this SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only on a when-and-if-available basis.

.10 If an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:
   • The price charged when the same element is sold separately
   • For an element not yet being sold separately, the price established by management having the relevant authority; it must be probable that the price, once established, will not change before the separate introduction of the element into the marketplace

The amount allocated to undelivered elements is not subject to later adjustment. However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5, Accounting for Contingencies. When a vendor’s pricing is based on multiple factors such as
the number of products and the number of users, the amount allocated to the same element when sold separately must consider all the factors of the vendor’s pricing structure.

.11 If a discount is offered in a multiple-element arrangement, a proportionate amount of that discount should be applied to each element included in the arrangement based on each element’s fair value without regard to the discount. However, as discussed in paragraph .37, no portion of the discount should be allocated to any upgrade rights. Moreover, to the extent that a discount exists, the residual method described in paragraph .12 attributes that discount entirely to the delivered elements.

.12 If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The following exceptions to this guidance are provided:

- If the only undelivered element is PCS, the entire fee should be recognized ratably (see paragraphs .56 through .62).
- If the only undelivered element is services that do not involve significant production, modification, or customization of software (for example, training or installation), the entire fee should be recognized over the period during which the services are expected to be performed (see paragraphs .63 through .71).
- If the arrangement is in substance a subscription, the entire fee should be recognized ratably (see paragraphs .48 and .49).
- If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs .43 through .47.
- There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

.13 The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph .08 of this SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.

.14 No portion of the fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee allocable to delivered elements is subject to forfeiture, refund, or other concession if any of the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may be persuasive, the following additional items should be considered:

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element
- Default and damage provisions as defined in the arrangement
Enforceable payment obligations and due dates for the delivered elements that are not dependent on the delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
Install and use of the delivered software
Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor’s historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

Evidence of an Arrangement

Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the packaged software sector) do not.

If the vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order from a third party or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

Even if all other requirements set forth in this SOP for the recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

Delivery

The second criterion in paragraph .08 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a user or a reseller. Except for arrangements in which the fee is a function of the number of copies, delivery is considered to have occurred upon the transfer of the product master or, if the product master is not to be delivered, upon the transfer of the first copy. For software that is delivered electronically, the delivery criterion of paragraph .08 is considered to have been met when the customer takes possession of the software via a download (that is, when the customer takes possession of the electronic data on its hardware), or has been provided with access codes that allow the customer to take immediate possession of the software on its hardware pursuant to an agreement or purchase order for the software. In such cases, revenue should be recognized if the other criteria of paragraph .08 have been satisfied.

Paragraphs .20 through .25 provide guidance on determining whether delivery is considered to have occurred in certain kinds of software transactions.

Customer Acceptance

After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

Determining Delivery—Multiple Copies of Software Products Versus Multiple Licenses

Arrangements to use multiple copies of a software product under site licenses with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

In the former kind of arrangement, duplication is incidental to the arrangement and the delivery criterion is met upon the delivery of the first copy or product master. The vendor may be obligated to furnish up to a specified number of
copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. If the other criteria in this SOP for revenue recognition are met, revenue should be recognized upon delivery of the first copy or product master. The estimated costs of duplication should be accrued at that time.

In the latter kind of arrangement, the licensing fee is a function of the number of copies delivered to, made by, or deployed by the user or reseller. Delivery occurs and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this SOP for revenue recognition are met.

Delivery Other Than to the Customer

.22 Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that other site.

Delivery Agents

.23 Vendors may engage agents, often referred to as fulfillment houses, to either duplicate and deliver or only deliver software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

Authorization Codes

.24 In a number of software arrangements, vendors use authorization codes, commonly referred to as keys, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for the duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

.25 In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is fully functional except for the permanent key or the additional keys (if additional keys are used to control the reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control the reproduction of the software).
- The vendor will enforce and does not have a history of failing to enforce its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, the delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys might indicate that collectibility is not probable or that the software is being used only for demonstration purposes.
Fixed or Determinable Fees and Collectibility

.26 The other prerequisites in paragraph .08 for revenue recognition are that (a) the vendor's fee is fixed or determinable and (b) collectibility is probable. A software licensing fee is not fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for variable-pricing arrangements is discussed in paragraphs .43 through .47 of this SOP. Additionally, if an arrangement includes (a) rights of return or (b) rights to refunds without return of the software, FASB Statement No. 48 requires that conditions that must be met in order for the vendor to recognize revenue include that the amount of future returns or refunds can be reasonably estimated.

Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible

.27 A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Because a product's continuing value may be reduced due to the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor still may provide a refund or concession to a creditworthy customer to liquidate outstanding amounts due under the original terms of the arrangement increases as payment terms become longer.

.28 For the reason cited in paragraph .27 any extended payment terms in a software licensing arrangement may indicate that the fee is not fixed or determinable. Further, if payment of a significant portion of the software licensing fee is not due until after expiration of the license or more than twelve months after delivery, the licensing fee should be presumed not to be fixed or determinable. However, this presumption may be overcome by evidence that the vendor has a standard business practice of using long-term or installment contracts and a history of successfully collecting under the original payment terms without making concessions. In such a situation, a vendor should consider such fees fixed or determinable and should recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this SOP have been satisfied.

.29 If it cannot be concluded that a fee is fixed or determinable at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming all other conditions for revenue recognition in this SOP have been satisfied).

.30 For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product.
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers.
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller.
- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has rights with respect to that product (sometimes referred to as price protection). If a vendor is unable to reasonably estimate future price changes in light of competitive conditions, or if significant uncertainties exist about the vendor's ability to maintain its price, the
arrangement fee is not fixed or determinable. In such circumstances, revenue from the arrangement should be deferred until the vendor is able to reasonably estimate the effects of future price changes and the other conditions of this SOP have been satisfied.

.31 Customer Cancellation Privileges. Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties for defective software, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

.32 Fiscal Funding Clauses. Fiscal funding clauses sometimes are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

.33 Consistent with FASB Technical Bulletin No. 79-10, Fiscal Funding Clauses in Lease Agreements, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraphs .27 and .28 of this SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit that is required to include such a clause creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this SOP have been satisfied.

Multiple-Element Arrangements

.34 As discussed in paragraph .09, multiple-element arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, individual elements in such arrangements should be accounted for in accordance with paragraphs .08 through .14. Paragraphs .35 through .73 provide guidance on the application of those paragraphs to multiple-element arrangements.

Additional Software Deliverables and Rights to Exchange or Return Software

.35 As part of a multiple-element arrangement, a vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include upgrades/enhancements or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware platform or operating system to one or more other platforms or operating systems (a platform-transfer right).

.36 Upgrades/enhancements. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and provide the customer with an upgrade right for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice. (Rights to receive unspecified upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this SOP.) The upgrade right should be accounted for as a separate element in accordance with paragraphs .08 through .14. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs .37 and .38.
.37 If a multiple-element arrangement includes an upgrade right, the fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right is the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. If the upgrade right is included in a multiple-element arrangement on which a discount has been offered (see paragraph .11), no portion of the discount should be allocated to the upgrade right. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

.38 The amount of the fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs .08 through .14 are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the fee to the upgrade right, revenue from the arrangement should be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered.

.39 Additional Software Products. As part of a multiple-element arrangement, a vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be included either in the terms of a PCS arrangement or in a separate agreement. Even if the rights to the additional software products are included in a PCS arrangement, the revenue allocable to the additional software products should be accounted for separately from the PCS arrangement as an element of a multiple-element arrangement.

.40 Multiple-element arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs .48 and .49) should be accounted for in accordance with paragraphs .08 through .14 of this SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs .41 through .47 below.

.41 The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraphs .10 and .11 of this SOP) of the products. If vendor-specific objective evidence of fair value does not exist, paragraph .12 of this SOP requires that all revenue from the arrangement be deferred until the earlier of the point at which (a) such sufficient vendor-specific objective evidence does exist or (b) all elements of the arrangement have been delivered. The fee allocated to the additional software products should not be reduced by the percentage of any customers that are not expected to exercise the right to receive additional software products.

.42 If the arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs .08 through .14 of this SOP are met.

.43 Some fixed fee license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue allocable to each software product is unknown and depends on the choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. Nevertheless, as discussed in paragraph .46 of this SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.
.44 In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer assuming the provisions of paragraphs .08 through .14 of this SOP are met, revenue should be recognized as copies of delivered products either (a) are reproduced by the customer or (b) are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or the first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At that point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraph .21 of this SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

.45 The revenue from the kind of arrangements discussed in paragraph .44 should not be recognized fully until at least one of the following conditions is met.
• Delivery is complete for all products covered by the arrangement.
• The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

.46 Nevertheless, certain arrangements that include products that are not deliverable at the inception impose a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming that the customer will elect to receive the maximum number of copies of the undeliverable product(s).

.47 The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces or receives enough copies of these delivered products so that revenue allocable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

.48 As part of a multiple-element arrangement with a user, a vendor may agree to deliver software currently and to deliver unspecified additional software products in the future (including unspecified platform transfer rights that do not qualify for exchange accounting as described in paragraphs .50 through .55). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. Nevertheless, they are distinguished from arrangements that include PCS because the future deliverables are products, not unspecified upgrades/enhancements.

.49 The software elements of the kinds of arrangements discussed in paragraph .48 should be accounted for as subscriptions. No allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. If the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product.

.50 Rights to Exchange or Return Software. As part of an arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, or features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude accounting for the transaction as either an
exchange or as a return. If the software is not returned physically and the customer contractually is entitled to continue to use the previously delivered software, the arrangement should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49). If the software is not returned physically and the customer contractually is not entitled to continue to use the previously delivered software, the transaction should be accounted for either as a return or as an exchange, as discussed in the following paragraphs.

.51 If the rights discussed in the previous paragraph are offered to users (but not resellers), the exchanges are analogous to "exchanges by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for dissimilar software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to arrangements that provide users with the rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates there will be no more than minimal differences in price, features, or functionality among the products in order for the right to qualify as a right to exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to the other product, the other product should be considered to have more than a minimal difference in functionality.

.52 As part of a multiple-element arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent an exchange, a return, or additional software products for accounting purposes. If the customer contractually is entitled to continue to use the software that was delivered originally (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section herein entitled "Additional Software Products" (see paragraphs .39 through .49).

.53 If, as part of a multiple-element arrangement, a vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs .08 through .14 of this SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as an exchange, if the platform-transfer right —

- Is for the same product (see paragraph .54)
- Does not increase the number of copies or concurrent users of the software product available under the license arrangement.

.54 Products are considered to be the same product if there are no more than minimal differences among them in price, features, and functions, and if they are marketed as the same product, even though there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.

.55 As part of their standard sales terms or as a matter of practice, vendors may grant resellers the rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph .51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

Postcontract Customer Support

.56 Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or unspecified upgrades/enhancements, or both, offered to users or resellers. A
vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with the services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

.57 If a multiple-element software arrangement includes explicit or implicit rights to PCS, the total fees from the arrangement should be allocated among the elements based on vendor-specific objective evidence of fair value, in conformity with paragraph .10. The fair value of the PCS should be determined by reference to the price the customer will be required to pay when it is sold separately (that is, the renewal rate). The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period if—

- Sufficient vendor-specific historical evidence exists demonstrating that costs to provide PCS are incurred on other than a straight-line basis. In making this determination, the vendor should take into consideration allocated portions of cost accounted for as research and development (R&D) costs and the amortization of costs related to the upgrade-enhancement capitalized in conformity with FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. Such costs should be considered as part of the costs to provide PCS.
- The vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern.

Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

.58 If sufficient vendor-specific objective evidence does not exist to allocate the fee to the separate elements and the only undelivered element is PCS, the entire arrangement fee should be recognized ratably over (a) the contractual PCS period (for those arrangements with explicit rights to PCS) or (b) the period during which PCS is expected to be provided (for those arrangements with implicit rights to PCS).

.59 PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met.

a. The PCS fee is included with the initial licensing fee.
b. The PCS included with the initial license is for one year or less.
c. The estimated cost of providing PCS during the arrangement is insignificant.
d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon the delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

.60 A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by the patterns of minimal and infrequent unspecified upgrades/enhancements offered in previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements
to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

.61 Postdelivery Telephone Support at No Additional Charge. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this SOP, regardless of whether the support is provided explicitly under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph .59, item (b) of this SOP. Accordingly, revenue allocable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph .59 of this SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue allocable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

.62 PCS Granted by Resellers. An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller’s customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller’s customers. If sufficient vendor-specific objective evidence does not exist to allocate the fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

Services

.63 Certain arrangements include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

.64 If an arrangement includes such services, a determination must be made as to whether the service element can be accounted for separately as the services are performed. Paragraph .65 discusses the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify for separate accounting as a service, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs .74 through .91 of this SOP address the application of contract accounting to software arrangements.

.65 In order to account separately for the service element of an arrangement that includes both software and services, sufficient vendor-specific objective evidence of fair value must exist to permit allocation of the revenue to the various elements of the arrangement (as discussed in paragraphs .10 and .12). Additionally, the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be described in the contract such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

.66 If an arrangement includes services that meet the criteria of paragraph .65 for separate accounting, revenue should be allocated among the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values. (Fair values are not necessarily the same as any separate prices stated for the separate elements of the arrangement.) Revenue allocated to the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed.

.67 If vendor-specific objective evidence of the fair value does not exist to allocate a portion of the fee to the service element, and the only undelivered element is services that do not involve
significant production, modification, or customization of the software (for example, training or installation), the entire arrangement fee should be recognized as the services are performed. If no pattern of performance is discernible, the entire arrangement fee should be recognized on a straight-line basis over the period during which the services are performed.

.68 An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered core or off-the-shelf software. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

.69 Software should be considered off-the-shelf software if it can be added to an arrangement with insignificant changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If significant modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if significant modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

.70 Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following.

- The software is not off-the-shelf software.
- The services include significant alterations to the features and functionality of the off-the-shelf software.
- Building complex interfaces is necessary for the vendor's software to be functional in the customer's environment.
- The timing of payments for the software is coincident with performance of the services.
- Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

.71 Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement always are stated separately and have one or more of the following characteristics.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.
- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

.72 Funded Software-Development Arrangements. Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:
• Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
• Discounts on future purchases by the funding party of products produced under the arrangement
• A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

.73 A funded software-development arrangement within the scope of FASB Statement No. 68, Research and Development Arrangements, should be accounted for in conformity with that Statement. If the technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of the development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed (that is, when the software is available for general release to customers and capitalization has ceased) should be credited to income.

Contract Accounting

.74 If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the service element does not meet the criteria for separate accounting set forth in paragraph .65. The entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1. Nevertheless, transactions that normally are accounted for as product sales should not be accounted for as long-term contracts merely to avoid the delivery requirements normally associated with product sales for revenue recognition.

.75 In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of the appropriate method should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1.

.76 Segmentation. Software contracts may have discrete elements that meet the criteria for segmenting in paragraphs 39 through 42 of SOP 81-1. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs .78 through .80 of this SOP.

.77 Some vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 are prohibited from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1.

.78 Measuring Progress-to-Completion Under the Percentage-of-Completion Method. Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows.

• Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units
produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as the completion of specific program modules.

.79 If, as discussed in paragraph .76 of this SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1, the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. The software vendor should choose measurement methods consistently, however, so that it uses similar methods to measure progress-to-completion on similar elements.

.80 Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are established more easily. As noted in paragraph 47 of SOP 81-1, "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 states that The acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

.81 Input Measures. Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point does not indicate progress-to-completion.

.82 Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

.83 Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and often are established more easily than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve the customization of core software.

.84 If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

.85 Output Measures. Progress on arrangements that call for the production of identifiable units of output can be measured in terms of the value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output
measures may be somewhat unreliable because of the difficulties associated with establishing them.

.86 In order for the value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are neither known nor reasonably estimable, they should not be used to measure progress-to-completion.

.87 If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more than minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

.88 Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

.89 Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

.90 Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

.91 The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

.92 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

13. AICPA Statement of Position 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition provides the following:

Conclusions

.05 The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph .03 of this SOP need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.06 All other provisions of SOP 97-2, including the remainder of paragraph 10, should be applied as stated in SOP 97-2. Accordingly, this SOP does not alter the requirements that (a) any allocation of the fee in a multiple-element arrangement to the various elements should be based on the fair values of each element, (b) those fair values must be supported by VSOE, and (c) in
instances where there is insufficient VSOE of the fair values of each element to allow for an allocation of revenue to each element, all revenue from the arrangement should be deferred pursuant to paragraph 12 of that SOP.

Effective Date and Transition

07 This SOP is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated to reflect the deferral of the effective date of the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 and the related examples noted in paragraph .03 of this SOP.

14. AICPA Statement of Position 98-9, Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions provides the following:

Conclusions

06 The following changes are made to SOP 97-2.

a. The following sentence is added to the end of paragraph 11 of SOP 97-2.
Moreover, to the extent that a discount exists, the residual method described in paragraph 12 [of SOP 97-2] attributes that discount entirely to the delivered elements.

b. The following is added to the end of paragraph 12 of SOP 97-2.
There may be instances in which there is vendor-specific objective evidence of the fair values of all undelivered elements in an arrangement but vendor-specific objective evidence of fair value does not exist for one or more of the delivered elements in the arrangement. In such instances, the fee should be recognized using the residual method, provided that (a) all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met and (b) the fair value of all of the undelivered elements is less than the arrangement fee. Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements, as indicated by vendor-specific objective evidence, is deferred and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

c. The following example is added to appendix A of SOP 97-2, following "Multiple Element Arrangements—Products and Services—Example 3."

**Multiple Element Arrangements—Products and Services—Example 4**
Facts
A vendor sells software product A for $950. The license arrangement for product A always includes one year of "free" PCS. The annual renewal price of PCS is $150.

Revenue Recognition
Assuming that, apart from the lack of vendor-specific objective evidence of the fair value of the delivered software element, all applicable revenue recognition criteria in this SOP [SOP 97-2] are met, revenue in the amount of $150 should be deferred and recognized in income over the one-year PCS service period. Revenue of $800 should be allocated to the software element and recognized upon delivery of the software.

Discussion
Vendor-specific objective evidence of the fair value of the software does not exist because the software is never sold separately. Consequently, sufficient vendor-specific objective evidence of fair value does not exist for the allocation of revenue to the various elements based on their relative fair values. Paragraph 12 of this SOP [SOP 97-2] states, however, that the residual method should be used when there is vendor-specific
objective evidence of the fair values of all undelivered elements; all other applicable revenue recognition criteria in this SOP [SOP 97-2] are met; and the fair value of all of the undelivered elements is less than the total arrangement fee.

If there had been vendor-specific objective evidence of the fair value of the delivered software but not of the undelivered PCS, the entire arrangement fee would be deferred and recognized ratably over the contractual PCS period in accordance with paragraphs 12 and 58 [of SOP 97-2].

.07 Paragraph 5 of SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition, is replaced with the following.

The second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2 which limit what is considered VSOE [vendor-specific objective evidence] of the fair value of the various elements in a multiple-element arrangement, and the related examples noted in paragraph 3 of this SOP [SOP 98-4] need not be applied to transactions entered into before fiscal years beginning after March 15, 1999.

.08 All provisions of SOP 97-2 for software transactions outside the scope of this SOP and all other provisions of SOP 97-2 for transactions within the scope of this SOP should be applied as stated in SOP 97-2.

Effective Date and Transition

.09 The provisions of this SOP that extend the deferral of the application of certain passages of SOP 97-2 are effective December 15, 1998. All other provisions of this SOP are effective for transactions entered into in fiscal years beginning after March 15, 1999. Earlier adoption is permitted as of the beginning of fiscal years or interim periods for which financial statements or information has not been issued. Retroactive application of the provisions of this SOP is prohibited.

15. EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware provides the following:

EITF 00-3 ISSUE

1. In connection with the licensing of software products, some vendors are offering arrangements in which end users of the software do not take possession of the software. Rather, the software application resides on the vendor's or a third party's hardware, and the customer accesses and uses the software on an as-needed basis over the Internet or via a dedicated line ("hosting").

2. Structurally, the form of those arrangements may be split into two elements-(a) the right to use software and (b) the hosting service. The arrangements may or may not include a license right to the software and the customer may or may not have an option to take delivery of the software.

3. SOP 97-2 establishes standards for recognition of revenue for licensing, selling, leasing, or otherwise marketing computer software. The scope of SOP 97-2 includes arrangements that provide for multiple deliverables (for example, software products and services), which are termed multiple elements. Under SOP 97-2, if an arrangement includes multiple elements, the fee should be allocated to the various elements based on vendor-specific objective evidence (VSOE) of fair value and recognized when certain criteria are met. One of the criteria for revenue recognition is that delivery has occurred. In addition, if a multiple-element arrangement includes both software and services, the portion of the fee allocable to the services is recognized separately as the services are performed, provided certain criteria are met.

4. The issues are:
Issue 1—Whether SOP 97-2 applies to arrangements that require the vendor to host the software.

Issue 2—Whether SOP 97-2 applies to arrangements in which the customer has an option to take delivery of the software. If so, when does delivery of the software occur and how does the vendor's hosting obligation impact revenue recognition?

EITF 00-3 DISCUSSION

5. The Task Force reached a consensus that a software element covered by SOP 97-2 is only present in a hosting arrangement if the customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty and it is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software. Therefore, SOP 97-2 only applies to hosting arrangements in which the customer has such an option. Arrangements that do not give the customer such an option are service contracts and are outside the scope of SOP 97-2. The Task Force observed that hosting arrangements that are service arrangements may include multiple elements that affect how revenue should be attributed.

6. The Task Force also reached a consensus that for those hosting arrangements in which the customer has the option, as described above, to take possession of the software, delivery of the software occurs when the customer has the ability to take immediate possession of the software. The Task Force observed that if the software element is within the scope of SOP 97-2, all of the SOP's requirements for recognizing revenue, including VSOE of fair value and the requirement that the fee allocated to the software element not be subject to forfeiture, refund, or other concession, must be met in order to recognize revenue upon delivery for the portion of the fee allocated to the software element. The portion of the fee allocated to the hosting element should be recognized as the service is provided. The Task Force noted that hosting arrangements that are, pursuant to this Issue, within the scope of SOP 97-2 may also include other elements, such as specified or unspecified upgrade rights, in addition to the software product and the hosting service.

7. The Task Force observed that if the vendor sells, leases, or licenses software that is within the scope of SOP 97-2, then the development costs of such software should be accounted for in accordance with Statement 86. Conversely, if the vendor never sells, leases, or licenses the software in an arrangement within the scope of SOP 97-2, then the software is utilized in providing services and the development costs of the software should be accounted for in accordance with SOP 98-1. However, if during such software's development or modification, the vendor develops a substantive plan to sell, lease, or otherwise market the software externally, the development costs of the software should be accounted for in accordance with Statement 86.

EITF 00-3 STATUS

8. No further EITF discussion is planned.

RELEVANT LITERATURE:

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Statement of Statutory Accounting Principles No. 5 - Liabilities, Contingencies and Impairments of Assets
- Statement of Statutory Accounting Principles No. 17 - Preoperating and Research and Development Costs
- Statement of Statutory Accounting Principles No. 22 - Leases
Generally Accepted Accounting Principles
- AICPA Statement of Position 97-2: *Software Revenue Recognition*
- AICPA Statement of Position 98-4: *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*
- AICPA Statement of Position 98-9: *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*
- EITF 00-3: Application of AICPA Statement of Position 97-2 to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware
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Statutory Issue Paper No. 112

Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs

STATUS
Finalized December 4, 2000

Type of Issue:
Common Area

SUMMARY OF ISSUE:

1. Current statutory accounting guidance for accounting for the costs of computer software developed or obtained for internal use and web site development costs is provided in Statement of Statutory Accounting Principles No. 16—Electronic Data Processing Equipment and Software (SSAP No. 16) and Statement of Statutory Accounting Principles No. 17—Preoperating and Research and Development Costs (SSAP No. 17). However, these SSAPs do not provide specific guidance on accounting for internal use software and web site development costs.

2. GAAP guidance for these issues is established in AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use (SOP 98-1) and FASB Emerging Issue Task Force 00-2, Accounting for Web Site Development Costs (EITF 00-2). Current statutory guidance is similar to GAAP, except that these issues are not specifically addressed.

3. The purpose of this issue paper is to add SOP 98-1 and EITF 00-2 and establish statutory accounting principles that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

4. This issue paper adopts SOP 98-1 paragraphs 11 through 42 and paragraph 93 with certain modifications. This issue paper also adopts EITF 00-2 in its entirety.

5. The modifications to SOP 98-1 are as follows:

a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This issue paper expands upon that paragraph to require that such costs shall be expensed as incurred.

b. Paragraph 32 is amended to require that entities who license internal-use computer software follow the operating lease provisions outlined in Statement of Statutory Accounting Principles No. 22—Leases (SSAP No. 22);

c. Paragraph 36 is amended to require that entities follow the amortization guidelines as established in paragraph 9 of Statement of Statutory Accounting Principles No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19);
d. Paragraph 37 is amended to require that capitalized operating system software shall be depreciated for a period not to exceed three years. Capitalized nonoperating system software shall be depreciated for a period not to exceed five years. This treatment is consistent with the guidelines of SSAP No. 16 and Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software (Issue Paper No. 109);

e. Paragraph 40 is amended to require that if during the development of internal-use software, an entity decides to market the software to others, the entity shall immediately expense any amounts previously capitalized;

f. Paragraph 41 is amended to require entities to follow the disclosure provisions outlined in paragraph 5 of SSAP No. 16 and paragraph 4 of SSAP No. 17;

g. Paragraph 42 is amended to require an effective date of January 1, 2002; and

h. Any software costs capitalized in accordance with this issue paper shall be deemed nonoperating system software costs. Nonoperating system software is a nonadmitted asset in accordance with SSAP No. 16.

6. In accordance with the reporting entity’s capitalization policy, immaterial amounts of such costs can be expensed when incurred.

**Effective Date and Transition**

7. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2002.

**DISCUSSION:**

8. The modifications to SOP 98-1 were made in order to maintain consistency with current statutory accounting principles and the Statement of Concepts.

a. Paragraph 11 states that the accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP. This issue paper expands upon that paragraph to require that such costs shall be expensed as incurred. This treatment is consistent with the GAAP equivalent contained within Emerging Issues Task Force Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*.  

b. Paragraph 32 states that even though FASB Statement No. 13, *Accounting for Leases* (FAS 13), excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement. The concepts outlined in FAS 13 are inconsistent with the provisions of SSAP, No. 22, therefore paragraph 32 was amended to require that licensing agreements shall be treated as operating leases;
c. Paragraph 36 was modified to remain consistent with the amortization guidelines contained within SSAP No. 19 paragraph 9;

d. Paragraph 37 was amended to remain consistent with the depreciable lives guidelines contained within SSAP No. 16 and the recently adopted Issue Paper No. 109;

e. Paragraph 40 requires that if, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (FAS No. 86). Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FAS No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FAS No. 86. Both paragraphs 8 and 10 are rejected in SSAP No. 17 and therefore the most conservative measure is to expense such amounts immediately;

f. Paragraph 41 includes references to various different GAAP pronouncements for its disclosure requirements. This paragraph was modified as SSAP Nos. 16 and 17 already include the pertinent disclosure requirements;

g. Paragraph 42 indicates that SOP 98-1 is effective for financial statements for fiscal years beginning after December 15, 1998. The paragraph was modified to allow an effective date of January 1, 2002 so as to provide ample opportunity for statutory accounting user implementation; and

h. In order to remain consistent with the treatment of nonoperating system software, the nonadmission criteria outlined in paragraph 2 of SSAP No. 16 were included in this issue paper. In order to prevent the possible misclassification of nonoperating system software as operating software, the working group felt it was appropriately conservative to classify all software costs capitalized in accordance with this issue paper as nonoperating system software costs. The Glossary to the SSAPs defines operating and nonoperating system software as:

The operating system is a program or a series of programs controlling the data job and task management operations of a computer or a computer network through executive scheduling and monitoring. It increases the productivity of a computer installation by managing the allocation of all available computer resources including the control processing unit, main storage and input/output devices.

Nonoperating systems software such as language processors, library routines and debugging aides and other computer software are not considered operating system software.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE:

Statutory Accounting
9. In general, capitalization of software is provided for in SSAP No. 16. This issue paper provides more specific guidelines for capitalization of internal software and web site development costs. SSAP No. 16 renders the following instruction:

2. EDP equipment and software generally meet the definition of assets established in SSAP No. 4—Assets and Nonadmitted Assets. EDP equipment and operating system software are
admitted assets to the extent they conform to the requirements of this statement. Nonoperating system software are nonadmitted assets.

3. EDP equipment and software shall be depreciated for a period not to exceed three years using methods detailed in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements.

4. The aggregate amount of admitted EDP equipment and operating system software (net of accumulated depreciation) shall be limited to three percent of the reporting entity's capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any EDP equipment and operating system software, net deferred tax assets and net positive goodwill.

Disclosures

5. The following disclosures shall be made in the financial statements:
   a. Depreciation and amortization expense for the period;
   b. For EDP equipment and operating system software, balances of major classes of depreciable assets, by nature or function, at the balance sheet date;
   c. For EDP equipment and operating system software, accumulated depreciation and amortization, either by major classes of depreciable assets or in total, at the balance sheet date; and
   d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

6. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 5 above shall be included in the annual audited statutory financial reports only.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

8. EDP equipment and software capitalized prior to January 1, 2001 shall be depreciated over the shorter of its remaining useful life or three years.

Generally Accepted Accounting Principles

10. AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use provides the following:

   .11 Accounting for costs of reengineering activities, which often are associated with new or upgraded software applications, is not included within the scope of this SOP.

Conclusions

Characteristics of Internal-Use Computer Software

.12 For purposes of this SOP, internal-use software is software having the following characteristics:

   a. The software is acquired, internally developed, or modified solely to meet the entity’s internal needs.
   b. During the software’s development or modification, no substantive plan exists or is being developed to market the software externally.
A substantive plan to market software externally could include the selection of a marketing channel or channels with identified promotional, delivery, billing, and support activities. To be considered a substantive plan under this SOP, implementation of the plan should be reasonably possible. Arrangements providing for the joint development of software for mutual internal use (for example, cost-sharing arrangements) are not substantive plans to market software for purposes of this SOP. Similarly, routine market feasibility studies are not substantive plans to market software for purposes of this SOP.

.13 An entity must meet both characteristics in paragraph .12 for software to be considered for internal use.

.14 An entity’s past practices related to selling software may help determine whether the software is for internal use or is subject to a plan to be marketed externally. For example, an entity in the business of selling computer software often both uses and sells its own software products. Such a past practice of both using and selling computer software creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

.15 Computer software to be sold, leased, or otherwise marketed includes software that is part of a product or process to be sold to a customer and should be accounted for under FASB Statement No. 86. For example, software designed for and embedded in a semiconductor chip is included in the scope of FASB Statement No. 86 because it is an integral part of the product. By contrast, software for internal use, though it may be used in developing a product, is not part of or included in the actual product or service sold. If software is used by the vendor in the production of the product or providing the service but the customer does not acquire the software or the future right to use it, the software is covered by this SOP. For example, for a communications company selling telephone services, software included in a telephone switch is part of the internal equipment used to deliver a service but is not part of the product or service actually being acquired or received by the customer.

.16 The Appendix [paragraph .93] provides examples of when computer software is and is not for internal use.

Stages of Computer Software Development

.17 The following table illustrates the various stages and related processes of computer software development.

<table>
<thead>
<tr>
<th>Preliminary Project Stage</th>
<th>Application Development Stage</th>
<th>Post-Implementation/Operation Stage</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Conceptual formulation of alternatives</td>
<td>• Design of chosen path, including software configuration and software interfaces</td>
<td>• Training</td>
</tr>
<tr>
<td>• Evaluation of alternatives</td>
<td>• Coding</td>
<td>• Application maintenance</td>
</tr>
<tr>
<td>• Determination of existence of needed technology</td>
<td>• Installation of hardware</td>
<td></td>
</tr>
<tr>
<td>• Final selection of alternatives</td>
<td>• Testing, including parallel processing phase</td>
<td></td>
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</tbody>
</table>

The SOP recognizes that the development of internal-use computer software may not follow the order shown above. For example, coding and testing are often performed simultaneously. Regardless, for costs incurred subsequent to completion of the preliminary project stage, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. For
example, while some training may occur in the application development stage, it should be expensed as incurred as required in paragraphs .21 and .23.

Research and Development

.18 The following costs of internal-use computer software are included in research and development and should be accounted for in accordance with the provisions of FAS No. 2:
   a. Purchased or leased computer software used in research and development activities where the software does not have alternative future uses.
   b. All internally developed internal-use computer software (including software developed by third parties, for example, programmer consultants) if (1) the software is a pilot project (that is, software of a nature similar to a pilot plant as noted in paragraph 9(h) of FASB Statement No. 2) or (2) the software is used in a particular research and development project, regardless of whether the software has alternative future uses.

Capitalize or Expense

.19 Preliminary Project Stage. When a computer software project is in the preliminary project stage, entities will likely—
   a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?
   b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
   c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.
   d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?
   e. Determine that the technology needed to achieve performance requirements exists.
   f. Select a vendor if an entity chooses to obtain software.
   g. Select a consultant to assist in the development or installation of the software.

.20 Internal and external costs incurred during the preliminary project stage should be expensed as they are incurred.

.21 Application Development Stage. Internal and external costs incurred to develop internal-use computer software during the application development stage should be capitalized. Costs to develop or obtain software that allows for access or conversion of old data by new systems should also be capitalized. Training costs are not internal-use software development costs and, if incurred during this stage, should be expensed as incurred.

.22 The process of data conversion from old to new systems may include purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system. Data conversion often occurs during the application development stage. Data conversion costs, except as noted in paragraph .21, should be expensed as incurred.

.23 Post-Implementation/Operation Stage. Internal and external training costs and maintenance costs should be expensed as incurred.

.24 Upgrades and Enhancements. For purposes of this SOP, upgrades and enhancements are defined as modifications to existing internal-use software that result in additional functionality—that is, modifications to enable the software to perform tasks that it was previously incapable of
performing. Upgrades and enhancements normally require new software specifications and may also require a change to all or part of the existing software specifications. In order for costs of specified upgrades and enhancements to internal-use computer software to be capitalized in accordance with paragraphs .25 and .26, it must be probable that those expenditures will result in additional functionality.

.25 Internal costs incurred for upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

.26 External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized in accordance with paragraphs .20–.23. (If maintenance is combined with specified upgrades and enhancements in a single contract, the cost should be allocated between the elements as discussed in paragraph .33 and the maintenance costs should be expensed over the contract period.) However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.

.27 Capitalization of costs should begin when both of the following occur.
  a. Preliminary project stage is completed.
  b. Management, with the relevant authority, implicitly or explicitly authorizes and commits to funding a computer software project and it is probable that the project will be completed and the software will be used to perform the function intended. Examples of authorization include the execution of a contract with a third party to develop the software, approval of expenditures related to internal development, or a commitment to obtain the software from a third party.

.28 When it is no longer probable that the computer software project will be completed and placed in service, no further costs should be capitalized, and guidance in paragraphs .34 and .35 on impairment should be applied to existing balances.

.29 Capitalization should cease no later than the point at which a computer software project is substantially complete and ready for its intended use. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed.

.30 New software development activities should trigger consideration of remaining useful lives of software that is to be replaced. When an entity replaces existing software with new software, unamortized costs of the old software should be expensed when the new software is ready for its intended use.

Capitalizable Costs

.31 Costs of computer software developed or obtained for internal use that should be capitalized include only the following:
  a. External direct costs of materials and services consumed in developing or obtaining internal-use computer software. Examples of those costs include but are not limited to fees paid to third parties for services provided to develop the software during the application development stage, costs incurred to obtain computer software from third parties, and travel expenses incurred by employees in their duties directly associated with developing software.
  b. Payroll and payroll-related costs (for example, costs of employee benefits) for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the
Examples of employee activities include but are not limited to coding and testing during the application development stage.

c. Interest costs incurred while developing internal-use computer software. Interest should be capitalized in accordance with the provisions of FASB Statement No. 34, Capitalization of Interest Cost.

General and administrative costs and overhead costs should not be capitalized as costs of internal-use software.

.32 Entities often license internal-use software from third parties. Though FASB Statement No. 13, Accounting for Leases, excludes licensing agreements from its scope, entities should analogize to that Statement when determining the asset acquired in a software licensing arrangement.

Multiple-Element Software Arrangements Included in Purchase Price

.33 Entities may purchase internal-use computer software from a third party. In some cases, the purchase price includes multiple elements, such as training for the software, maintenance fees for routine maintenance work to be performed by the third party, data conversion costs, reengineering costs, and rights to future upgrades and enhancements. Entities should allocate the cost among all individual elements. The allocation should be based on objective evidence of fair value of the elements in the contract, not necessarily separate prices stated within the contract for each element. Those elements included in the scope of this SOP should be accounted for in accordance with the provisions of this SOP.

Impairment

.34 Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. Paragraph 8 of FASB Statement No. 121 requires that assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. FASB Statement No. 121 guidance is applicable, for example, when one of the following occurs related to computer software being developed or currently in use:
   a. Internal-use computer software is not expected to provide substantive service potential,
   b. A significant change occurs in the extent or manner in which the software is used or is expected to be used,
   c. A significant change is made or will be made to the software program,
   d. Costs of developing or modifying internal-use computer software significantly exceed the amount originally expected to develop or modify the software.

.35 Paragraph 10 of FASB Statement No. 121 requires that “if the asset is not expected to provide any service potential to the entity, the asset shall be accounted for as if abandoned or held for disposal in accordance with the provisions of paragraph 15 of [FASB Statement No. 121].” When it is no longer probable that computer software being developed will be completed and placed in service, the asset should be reported at the lower of the carrying amount or fair value, if any, less costs to sell. The rebuttable presumption is that such uncompleted software has a fair value of zero. Indications that the software may no longer be expected to be completed and placed in service include the following:
   a. A lack of expenditures budgeted or incurred for the project
   b. Programming difficulties that cannot be resolved on a timely basis
   c. Significant cost overruns
   d. Information has been obtained indicating that the costs of internally developed software will significantly exceed the cost of comparable third-party software or software products, so that management intends to obtain the third-party software or software products instead of completing the internally developed software
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e. Technologies are introduced in the marketplace, so that management intends to obtain the third-party software or software products instead of completing the internally developed software.
f. Business segment or unit to which the software relates is unprofitable or has been or will be discontinued.

Amortization

.36 The costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software’s use.

.37 In determining and periodically reassessing the estimated useful life over which the costs incurred for internal-use computer software will be amortized, entities should consider the effects of obsolescence, technology, competition, and other economic factors. Entities should consider rapid changes that may be occurring in the development of software products, software operating systems, or computer hardware and whether management intends to replace any technologically inferior software or hardware. Given the history of rapid changes in technology, software often has had a relatively short useful life.

.38 For each module or component of a software project, amortization should begin when the computer software is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond a reporting period. For purposes of this SOP, computer software is ready for its intended use after all substantial testing is completed. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

Internal-Use Computer Software Marketed

.39 If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, such as commissions, software reproduction costs, warranty and service obligations, and installation costs, should be applied against the carrying amount of that software. No profit should be recognized until aggregate net proceeds from licenses and amortization have reduced the carrying amount of the software to zero. Subsequent proceeds should be recognized in revenue as earned.

.40 If, during the development of internal-use software, an entity decides to market the software to others, the entity should follow FASB Statement No. 86. Amounts previously capitalized under this SOP should be evaluated at each balance sheet date in accordance with paragraph 10 of FASB Statement No. 86. Capitalized software costs should be amortized in accordance with paragraph 8 of FASB Statement No. 86. A pattern of deciding to market internal-use software during its development creates a rebuttable presumption that any software developed by that entity is intended for sale, lease, or other marketing, and thus is subject to the guidance in FASB Statement No. 86.

Disclosures

.41 This SOP does not require any new disclosures; disclosure should be made in accordance with existing authoritative literature, including Accounting Principles Board (APB) Opinion No. 12, Disclosure of Depreciable Assets and Depreciation; APB Opinion No. 22, Disclosure of Accounting Policies (for example, amortization methods); FASB Statement Nos. 2 and 121; and SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties.
Effective Date and Transition

.42 This SOP is effective for financial statements for fiscal years beginning after December 15, 1998, and should be applied to internal-use computer software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of this SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued.

Appendix

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Examples Illustrating When Computer Software Is for Internal Use

1. A manufacturing entity purchases robots and customizes the software that the robots use to function. The robots are used in a manufacturing process that results in finished goods.
2. An entity develops software that helps it improve its cash management, which may allow the entity to earn more revenue.
3. An entity purchases or develops software to process payroll, accounts payable, and accounts receivable.
4. An entity purchases software related to the installation of an online system used to keep membership data.
5. A travel agency purchases a software system to price vacation packages and obtain airfares.
6. A bank develops software that allows a customer to withdraw cash, inquire about balances, make loan payments, and execute wire transfers.
7. A mortgage loan servicing entity develops or purchases computer software to enhance the speed of services provided to customers.
8. A telecommunications company develops software to run its switches that are necessary for various telephone services such as voice mail and call forwarding.
9. An entity is in the process of developing an accounts receivable system. The software specifications meet the company’s internal needs and the company did not have a marketing plan before or during the development of the software. In addition, the company has not sold any of its internal-use software in the past. Two years after completion of the project, the company decided to market the product to recoup some or all of its costs.
10. A broker-dealer entity develops a software database and charges for financial information distributed through the database.
11. An entity develops software to be used to create components of music videos (for example, the software used to blend and change the faces of models in music videos). The entity then sells the final music videos, which do not contain the software, to another entity.
12. An entity purchases software to computerize a manual catalog and then sells the manual catalog to the public.
13. A law firm develops an intranet research tool that allows firm members to locate and search the firm’s databases for information relevant to their cases. The system provides users with the ability to print cases, search for related topics, and annotate their personal copies of the database.

Examples Illustrating When Computer Software Is Not Internal Use

14. An entity sells software required to operate its products, such as robots, electronic game systems, video cassette recorders, automobiles, voice-mail systems, satellites, and cash registers.
15. A pharmaceutical company buys machines and writes all of the software that allows the machines to function. The pharmaceutical company then sells the machines, which help control the dispensation of medication to patients and help control inventory, to hospitals.
16. A semiconductor entity develops software embedded in a microcomputer chip used in automobile electronic systems.
17. An entity purchases software to computerize a manual catalog and then sells the computer version and the related software to the public.
18. A software company develops an operating system for sale and for internal use. Though the specifications of the software meet the company's internal needs, the company had a marketing plan before the project was complete. In addition, the company has a history of selling software that it also uses internally and the plan has a reasonable possibility of being implemented.

19. An entity is developing software for a point-of-sale system. The system is for internal use; however, a marketing plan is being developed concurrently with the software development. The plan has a reasonable possibility of being implemented.

20. A telecommunications entity purchases computer software to be used in research and development activities.

21. An entity incurs costs to develop computer software for another entity under a contract with that other entity.

7. EITF 00-2 provides the following:

EITF 00-2 ISSUE

1. Companies are incurring significant costs to develop Internet web sites. These companies may be "Internet" companies, traditional "brick and mortar" companies, or service companies. The web sites may be used to promote or advertise products or services, supplant manual processes or services, sell products (including software) or services, or to do a combination of all three. Further, due to rapid changes in technology, new uses for web sites are being developed. Diversity in practice exists in accounting for web site development costs. Some entities capitalize web site development costs, others expense such costs, and still others capitalize some of those costs and expense the rest.

2. The issue is how an entity should account for costs incurred to develop a web site.

EITF 00-2 DISCUSSION

3. The Task Force discussed the accounting for web site development costs and reached the following consensuses.

Costs Incurred in the Planning Stage

4. Planning stage activities are described in detail in Exhibit 00-2A. The Task Force reached a consensus that, regardless of whether the web site planning activities specifically relate to software, all costs incurred in the planning stage should be expensed as incurred.

Costs Incurred in the Web Site Application and Infrastructure Development Stage

5. As described in Exhibit 00-2A, the web site application and infrastructure development stage involves acquiring or developing hardware and software to operate the web site. The cost of hardware is outside the scope of this Issue. SOP 98-1 provides guidance for distinguishing between internal-use software and software to be sold, leased, or otherwise marketed. A key aspect of the definition of internal-use software is that it excludes software for which a plan exists or for which a plan is being developed to market the software externally. The Task Force reached a consensus that all costs relating to software used to operate a web site should be accounted for under SOP 98-1 unless a plan exists or is being developed to market the software externally, in which case the costs relating to the software should be accounted for pursuant to Statement 86. Fees incurred for web site hosting, which involve the payment of a specified, periodic fee to an Internet service provider in return for hosting the web site on its server(s) connected to the Internet, generally would be expensed over the period of benefit.

Costs Incurred to Develop Graphics
6. For purposes of this Issue, graphics involve the overall design of the web page (use of borders, background and text colors, fonts, frames, buttons, and so forth) that affect the "look and feel" of the web page and generally remain consistent regardless of changes made to the content. The Task Force reached a consensus that graphics are a component of software and that the costs of developing initial graphics should be accounted for pursuant to SOP 98-1 for internal-use software, and pursuant to Statement 86 for software marketed externally. Modifications to graphics after a web site is launched should be evaluated to determine whether the modifications represent maintenance or enhancements of the web site. The accounting for maintenance and enhancements is discussed in paragraph 8.

Costs Incurred to Develop Content

7. Content refers to information included on the web site, which may be textual or graphical in nature (although the specific graphics described in paragraph 6, above, are excluded from content). For example, articles, product photos, maps, and stock quotes and charts are all forms of content. Content may reside in separate databases that are integrated into (or accessed from) the web page with software, or it may be coded directly into the web pages. The Task Force observed that the accounting for web site content involves issues that also apply to other forms of content or information that are not unique to web sites. Accordingly, the Task Force concluded that the accounting for content should be addressed as a separate EITF Issue.

Costs Incurred in the Operating Stage

8. As described in Exhibit 00-2A, costs incurred during the operating stage include training, administration, maintenance, and other costs to operate an existing web site. The Task Force reached a consensus that the costs of operating a web site should not be accounted for differently from the costs of other operations; that is, those costs should be expensed as incurred. However, costs incurred in the operation stage that involve providing additional functions or features to the web site should be accounted for as, in effect, new software. That is, costs of upgrades and enhancements that add functionality should be expensed or capitalized based on the general model of SOP 98-1 (which requires certain costs relating to upgrades and enhancements to be capitalized if it is probable that they will result in added functionality) or, for software that is marketed, Statement 86 (which applies its software capitalization model to "product enhancements," which include improvements that extend the life or significantly improve the marketability of a product). The Task Force observed that the determination of whether a change to web site software results in (a) an upgrade or enhancement, if internal-use software, or (b) a product enhancement, if externally marketed software, is a matter of judgment based on the specific facts and circumstances. The Task Force also observed that SOP 98-1 indicates that entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements must expense such costs as incurred.

Transition

9. The consensuses in this Issue are effective for web site development costs incurred for fiscal quarters beginning after June 30, 2000 (including costs incurred for projects in process as of the beginning of the quarter of adoption of these consensuses). Earlier application is encouraged. The Task Force observed that an entity may elect to adopt the consensuses as a cumulative effect of a change in accounting principles in accordance with Opinion 20.

10. Exhibit 00-2A illustrates the application of the above-described consensuses to specific web site development costs.

EITF 00-2 STATUS

11. No further EITF discussion is planned.
### Planning Stage

<table>
<thead>
<tr>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Develop a business, project plan, or both. This may include identification of specific goals for the web site (for example, to provide information, supplant manual processes, conduct e-commerce, and so forth), a competitive analysis, identification of the target audience, creation of time and cost budgets, and estimates of the risks and benefits.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>b. Determine the functionalities (for example, order placement, order and shipment tracking, search engine, e-mail, chat rooms, and so forth) of the web site.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>c. Identify necessary hardware (for example, the server) and web applications. Web applications are the software needed for the web site's functionalities. Examples of web applications are search engines, interfaces with inventory or other back-end systems, as well as systems for registration and authentication of users, commerce, content management, usage analysis, and so forth.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>d. Determine that the technology necessary to achieve desired functionalities exists. Factors might include, for example, target audience numbers, user traffic patterns, response time expectations, and security requirements.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>e. Explore alternatives for achieving functionalities (for example, internal versus external resources, custom-developed versus licensed software, company-owned versus third-party-hosted applications and servers).</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>f. Conceptually formulate and/or identify graphics and content (refer to “Graphics and Content Development Stages” for further discussion).</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>g. Invite vendors to demonstrate how their web applications, hardware, or service will help achieve the web site's functionalities.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>h. Select external vendors or consultants.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>i. Identify internal resources for work on the web site design and development.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>j. Identify software tools and packages required for development purposes.</td>
<td>Expense as incurred.</td>
</tr>
<tr>
<td>k. Address legal considerations such as privacy, copyright, trademark, and compliance.</td>
<td>Expense as incurred.</td>
</tr>
</tbody>
</table>
### Web Site Application and Infrastructure Development Stage

<table>
<thead>
<tr>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>The discussion of web site application and infrastructure development assumes that any software is developed for the entity's internal needs and no plan exists or is being developed to market the software externally (refer to paragraph 12 of SOP 98-1). Software for which a plan exists or is being developed to market the software externally is subject to Statement 86, and costs associated with the development of that software should be expensed until technological feasibility is established (refer to paragraph 4 of Statement 86).</td>
<td></td>
</tr>
</tbody>
</table>

**a. Acquire or develop the software tools required for the development work (for example, HTML editor, software to convert existing data to HTML form, graphics software, multimedia software, and so forth).**

Apply SOP 98-1. Costs incurred to purchase software tools, or costs incurred during the application development stage for internally developed tools, generally should be capitalized unless they are used in research and development and (1) do not have any alternative future uses or (2) are internally developed and represent a pilot project or are being used in a specific research and development project (see paragraph 18 of SOP 98-1).

**b. Obtain and register an Internet domain name.**

Generally, capitalize pursuant to paragraph 24 of APB 17.

**c. Acquire or develop software necessary for general web site operations, including server operating system software, Internet server software, web browser software, and Internet protocol software.**

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

**d. Develop or acquire and customize code for web applications (for example, catalog software, search engines, order processing systems, sales tax calculation software, payment systems, shipment tracking applications or interfaces, e-mail software, and related security features).**

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

**e. Develop or acquire and customize database software and software to integrate distributed applications (for example, corporate databases and accounting systems) into web applications.**

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

**f. Develop HTML web pages or develop templates and write code to automatically create HTML pages.**

Apply SOP 98-1. Generally, capitalize pursuant to paragraphs 21 and 31 of SOP 98-1.

**g. Purchase the web and application server(s), Internet connection (bandwidth), routers, staging servers (where preliminary changes to the web site are made in a test environment), and production servers (accessible to customers using the web site). Alternatively, these services may be provided by a third party via a hosting arrangement.**

Acquisitions of servers and related hardware infrastructure are outside the scope of this issue. Payments for hosting arrangements should be expensed over the period of benefit.
### Operating Stage

<table>
<thead>
<tr>
<th>Web Site Development Activity</th>
<th>Accounting Required by Issue 00-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Train employees involved in support of the web site.</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
<tr>
<td>b. Register the web site with Internet search engines.</td>
<td>Expense as incurred. These expenditures represent advertising costs and are expensed as incurred pursuant to paragraph 26 of SOP 93-7.</td>
</tr>
<tr>
<td>c. Perform user administration activities.</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
<tr>
<td>d. Update site graphics (for updates of graphics related to major enhancements, refer to (h), below).</td>
<td>Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.</td>
</tr>
</tbody>
</table>
e. Perform regular backups.  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

f. Create new links.  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

g. Verify that links are functioning properly and update existing links (that is, link management or maintenance).  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

h. Add additional functionalities or features.  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

i. Perform routine security reviews of the website and, if applicable, of the third-party host.  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

j. Perform usage analysis.  
Apply SOP 98-1. Generally, expense as incurred pursuant to paragraph 23 of SOP 98-1.

RELEVANT LITERATURE:

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Statement of Statutory Accounting Principles No. 16—Electronic Data Processing Equipment and Software
- Statement of Statutory Accounting Principles No. 17—Preoperating and Research and Development Costs
- Statement of Statutory Accounting Principles No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
- Statement of Statutory Accounting Principles No. 22—Leases
- Issue Paper No. 109—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16—Electronic Data Processing Equipment and Software

Generally Accepted Accounting Principles
- AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use
- EITF 00-2, Accounting for Web Site Development Costs
Statutory Issue Paper No. 113

Mezzanine Real Estate Loans

STATUS
Finalized June 11, 2001

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for the accounting and reporting guidelines of Mezzanine Real Estate Loans (MREL).

SUMMARY CONCLUSION

2. For statutory accounting purposes, a MREL shall be defined as a debt obligation that is not a security, which is secured by a pledge of equity interest in an entity that owns real estate. (A security is a share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer) that:

   a. Either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer;

   b. Is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and

   c. Either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).

3. MREL’s meet the definition of assets as specified in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

4. Reporting entities holding MREL’s shall follow the accounting and disclosure requirements defined within SSAP No. 37—Mortgage Loans (SSAP No. 37).

5. In order for a MREL to qualify as an admitted asset, the MREL agreement (the agreement) shall:

   a. Require that each pledgor abstain from granting additional security interests in the equity interest pledged; and

   b. In addition to satisfaction of the requirements set forth in paragraphs c and d below, the MREL lender shall employ techniques to minimize the likelihood or impact of a bankruptcy filing on the part of the real estate owner and, if different, on the part of the mezz borrower. These techniques may include (by way of example and not limitation) one or more of the following: (i) separateness covenants, (ii) cash management techniques, (iii) exceptions to the non-recourse provisions for damages arising out of the mezz borrower’s failure to comply with covenants prohibiting additional debt, transfers of the real estate, transfers of pledged interests, and violation of the single asset/single purpose covenants, (iv) full recourse liability in the event of a bankruptcy filing on the
part of the real estate owner and, if different, on the part of the mezz borrower, and (v) loan guaranties; and

The selection of techniques that are applied in the instance of any particular MREL to achieve said purposes requires an exercise of judgment by the MREL lender. The reasonableness of the techniques utilized in any particular MREL will be assessed in light of the credit characteristics of the MREL borrower, any guarantors and the underlying real estate at the time of origination. Utilizing this standard provides flexibility to the MREL lender and provides a basis for the regulator and auditor in analyzing the reasonableness of the judgment of the MREL lender; and

c. The real estate owner and, if different, the mezz borrower shall:

i. Hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower (if different), the equity interest in the real estate owner;

ii. Not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower (if different), holding an ownership interest in the real estate owner; and

iii. Not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower, if different).

d. At the time of the initial investment, the MREL lender shall corroborate that the sum of the first mortgage and the MREL does not exceed 100% of the value of the real estate as evidenced by a current appraisal. Acceptable appraisal methods are described in paragraph 11 of SSAP No. 40—Real Estate Investments.

e. The MREL lender shall report in Appendix A-001 to its annual statement the amount and percentages of its total admitted assets held in MREL and the largest three investments held in MREL except that such detail shall not be required for assets held in MREL totaling less than 2.5% of its total admitted assets.

Effective Date
6. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date for years ending on or after December 31, 2001.

DISCUSSION

Definition of MREL

7. An MREL is a loan secured by a pledge of direct or indirect equity interests in an entity that owns real estate (the “real estate owner”). The real estate owner is typically the borrower under a mortgage loan secured by the same real estate. The MREL borrower (“mezz borrower”) may be the real estate owner or one or more of the holder(s) of the direct or indirect equity interest(s) in the real estate owner. As used herein, “direct equity interests” means the then issued and outstanding shares or units of partnership, membership or other beneficial interests in the real estate owner, and “indirect equity interests” means the then issued and outstanding shares or units of partnership, membership or other
beneficial interests in a member, partner, shareholder or other holder of direct equity interests in the real estate owner. The following illustrates one typical MREL structure:

**Typical Sources and Market Characteristics of MRELs**

8. Significant portions of large real estate loans are now originated with the intent of securitizing the real estate mortgage loan. Mortgage loans targeted for securitization are typically subject to uniform underwriting and structuring requirements, including requirements that (a) the mortgage loan satisfy a loan to value ratio of 65% or less, (b) prohibit encumbrance of the real estate to secure additional debt, and (c) the borrower satisfy certain SPE (special purpose entity) requirements (as described below).

9. In many instances, the subject real estate project requires financing in excess of 65% of the value of the property. By utilizing a MREL, the real estate owner is able to obtain a low cost first mortgage loan and the mezz borrower is able to obtain additional project financing in the form of the MREL without jeopardizing the securitization of the first mortgage loan by subjecting the real estate to additional liens.

10. Like its securitized mortgage loan counterpart, MRELs typically have common underwriting and structuring characteristics. As noted above, MRELs are secured by a pledge of the mezz borrower’s equity interest in the real estate owner. Similar to securitized loan requirements, the documents evidencing the MREL require that (a) the mezz borrower abstain from granting additional security interests in its equity interest in the real estate owner, and (b) both the real estate owner and the mezz borrower be a special purpose, bankruptcy remote corporation, limited liability company or limited partnership (a “SPE”). In the case of a limited partnership SPE, the general partner of such SPE must in turn be a SPE (and if the real estate owner is a limited partnership, the general partnership interest is also pledged to secure the MREL). The SPE requirements are intended to protect both the mortgage lender and the MREL lender from the risks associated with bankruptcy filings and consolidation of claims relating to affiliated entities.2

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1 A “securitized” real estate loan is a loan combined with other loans secured by real estate for sale in the secondary market, typically in the form of a commercial mortgaged backed security.

2 In order to comply with typical SPE requirements, an entity must, among other things: (i) hold no assets other than, in the case of the real estate owner, the real property, and in the case of the mezz borrower, the equity interest in the real estate owner; (ii) not engage in any business other than, in the case of the real estate owner, the ownership and operation of the real estate, and in the case of the mezz borrower, the ownership of the real estate owner; (iii) not incur additional debt, other than limited trade payables, a first mortgage loan (in the case of the real estate owner), and the MREL (in the case of the mezz borrower); and (iv) have at all times an independent director or member whose vote is required for, among other things, a voluntary bankruptcy filing.
MREL Lender Remedies

11. Should the mezz borrower default on its obligations under the MREL, the MREL lender has the right to assume ownership and control of the real estate owner by realizing upon its security interest in the equity interest in the real estate owner. Similar to foreclosure of a junior mortgage position, the goal of this remedy is to gain control over the ownership and operation of the real estate and thereby preserve both the good standing of the mortgage loan and the equity in the real estate that will ultimately repay the MREL.

12. Unlike foreclosure of a junior mortgage, the remedies afforded a MREL lender can typically be exercised very quickly and reach conclusion much faster than foreclosure; in most jurisdictions, a MREL lender can exercise remedies under the applicable Uniform Commercial Code (UCC)3 without the need for judicial action. Further, most MRELs are structured with cash management requirements that protect both the mortgage lender and the MREL lender from misapplication of rents and other income generated by the real estate. Finally, unlike most holders of junior mortgage liens, MREL lenders are typically able to negotiate notice and cure rights from the holders of the mortgage debt. These rights give the MREL lender the ability to preserve the good standing of the mortgage loan (thereby avoiding accrual of default interest and ultimately foreclosure) while the MREL lender exercises its remedies and gains control over the real estate, while remaining subordinate to the first mortgage obligation.

Remedy Comparison

13. Below is a description of several different forms of subordinated real estate investments, the security that the investment relies upon for repayment and the related default/foreclosure scenarios for each type of investment:

<table>
<thead>
<tr>
<th>First Mortgage</th>
<th>Second Mortgage</th>
<th>Mezzanine Real Estate Loan</th>
<th>Comm. Mtg Back Security (AA &amp; Down)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Security</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First lien on property (deed of trust)</td>
<td>Second lien on property (deed of trust)</td>
<td>Lien on ownership interest in the real estate owner</td>
<td>Rights to subordinated cash flow from trust</td>
</tr>
<tr>
<td>Default/Foreclosure Remedy</td>
<td>Become owner of property free and clear of all liens</td>
<td>Become owner of property subject to first mortgage</td>
<td>Become holder of subordinated interest in cash flow and prop. Residual</td>
</tr>
<tr>
<td>Comment</td>
<td>If 1st mortgage not kept/brought current by 2nd then 1st may foreclose</td>
<td>If 1st mortgage not kept/brought current by MREL Lender then 1st may foreclose</td>
<td></td>
</tr>
</tbody>
</table>
payment, and in a default scenario both ultimately result in the lender controlling real property with a first mortgage in place that requires current payments.

15. Foreclosure of a second mortgage varies by state law (judicial vs. statutory) and for a MREL is generally the same in all states under the UCC. The MREL remedy process is typically quicker than the judicial process and is similar in time to states with a statutory foreclosure process.

16. MRELs are also documented with monthly payment requirements and hard maturity dates. Like loans secured by a second mortgage, MRELs' typical return characteristics do not vary with the amount of cash flow available for payment. MRELs are passive investments, with no or very little authority over management of the real property prior to default, but similar to other debt instruments have protective covenants (rules), which, if violated, trigger the right to exercise the remedies discussed above.

17. MRELs meet the definition of assets as specified in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of SSAP 37 and this issue paper (particularly, paragraph 5). Recording MRELs as admitted assets is consistent with the recognition concept in the Statement of Concepts (i.e., the existence of readily marketable assets available when both current and future obligations are due). Due to their similarity to second mortgages, the requirement to account and disclose MRELs in accordance with SSAP No. 37 is concordant with the principle of consistency in the Statement of Concepts.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
18. As MRELs are not currently defined or identified as admitted assets within the Accounting Practices and Procedures Manual, they are currently nonadmitted in accordance with SSAP No. 4.

19. The Invested Assets Working Group addressed the admissibility of MRELs at its August 28, 2000 working group meeting. The following represents an excerpt from a report containing its recommendation as to the admissibility of such assets:

In addition to reviewing the material you provided, the IAWG also heard a presentation (including recommendations) from Interested Persons on Mezzanine Loans. The IAWG agrees that Mezzanine Loans meet the definition of assets contained in SSAP 4, Assets and Nonadmitted Assets and should be admitted assets if they conform to the requirements of SSAP 37, Mortgage Loans. However, we also believe Mezzanine Loans should be treated as an entirely new type of asset class. Accordingly, the IAWG recommends that any proposed regulatory accounting guidance first precisely define a mezzanine loan by reference to its structural features and legal characteristics. For example, we understand that the borrower takes ownership rights in the entity owning the property. This legal interest is not the same thing as an interest in real estate secured by a mortgage lien. Therefore, it will be important to identify how the state Uniform Commercial Code will define an ownership interest and how an insurer investor perfects a security interest in ownership rights. Ownership rights in the entity may also subject the insurer to owner related liabilities that should be considered in accounting guidance. Further, to the extent the real estate is to play a significant role in recovering the value of the loan in a default situation, it is also important to understand how the insurer effectively ensures that the borrower cannot further encumber its real estate. In this regard, the IAWG noted that the written discussion paper presented by the Interested Persons did not provide an authoritative description of the structural or other characteristics of this type of asset. The IAWG also recommends that the Risk Based Capital Task Force should determine the appropriate Risk Based Capital treatment for Mezzanine Loans.

Generally Accepted Accounting Principles
RELEVANT LITERATURE

Statutory Accounting
– Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
– SSAP No. 4—Assets and Nonadmitted Assets
– SSAP No. 37—Mortgage Loans

Generally Accepted Accounting Principles
– FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises
– FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
– FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan
– FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, an amendment of FASB Statement No. 114
– FASB Emerging Issues Task Force Issue No. 84-19, Mortgage Loan Payment Modifications
– FASB Emerging Issues Task Force Issue 88-17, Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations
– AICPA Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans
Uniform Commercial Code Questions and Answers

As further background on the treatment and structure of a mezzanine real estate loan, the following questions and answers are presented.

1. How is a security interest of this type characterized under the UCC?

   - Either investment property, general intangible or instrument
   - Security interest in shares of a corporation should be investment property. See § 9-102(a)(49); § 8-102(a)(15); § 8-103(a)
   - Partnership or limited liability company- generally a general intangible. See § 9-102(a)(42)
   - If such interests represented in writing could be classified as “instruments”. See § 9-102(47).
   - Require borrowers to opt into Article 8. See § 8-102(a)(15)(iii)(b) investment property.

2. How does the insurer perfect its security interest?

   - A security interest in investment property is perfected by either obtaining “control”, See § 9-314, or filing a financing statement. See § 9-312(a).
   - An interest that is perfected by control has priority over one perfected by filing. See § 9-328.
   - A secured party has control of investment property when the secured party may transfer that property without further consent from the owner. See § 8-106.
   - If the collateral is a certificated security in bearer form control is achieved by possession. See § 8-106(a).
   - If the collateral is a certificated security in registered form control is achieved when the secured party takes possession of the certificate and the certificate is endorsed to the party or is registered in the party’s name upon issue or transfer. See § 8-106(b). Certificated securities are accompanied by executed stock powers.
   - If the collateral is an uncertificated security control is achieved by “delivery” of the security, which can be achieved by the secured party becoming the registered owner, or the issuer providing that it will comply with instructions of the secured party without further action from the registered owner. See § 8-106(c). A pledge or security interest in uncertificated securities is typically acknowledged by the issuer delivering an “Initial Transaction Statement”. See § 8-408.
   - An interest in a general intangible is perfected by filing a financing statement. See § 9-310.
   - An interest in an instrument may be perfected by filing a financial statement, See § 9-312(a), or by possession. See § 9-313.
   - Security interest extends to all proceeds generated by the pledged securities. See § 9-306(1).
   - Typically, regardless of the nature of the securities pledged, the secured party will file UCC financing statements as a precautionary measure.

3. What steps does the insurer take to realize on the collateral?

   - Once the borrower is in default, the secured party may possess the collateral either through the judicial process or any other peaceful means. See § 9-610(b).
   - If the secured party has perfected by control it has the ability to foreclose on the collateral without additional steps. See § 9 - 601.
   - The UCC provides that disposition of collateral following default must be conducted in a commercially reasonable manner. See § 9-610(b).
4. Does the answer differ under the old UCC and the amended UCC, due to take effect in 2001?

- The most significant change relevant to these transactions is that a security interest in an instrument may now be perfected by filing; where the prior Article 9 allowed perfection of an instrument only by possession. See § 9-312(a).
- Where a subsequent purchaser is unaware of the secured party’s interest, the interest may be extinguished upon purchase. See § 9-330(d). This risk is minimized by the secured party obtaining an Initial Transaction Statement confirming registration of the pledge of uncertificated securities and by the secured party taking possession of certificated securities together with executed stock powers.
- The filing of a financing statement does not constitute notice. See § 9-331.

5. Could a fraudulent borrower further encumber the real estate and thus defeat the insurer’s interest in the real estate?

Yes, but some factors that mitigate the risk:

- Typically, a mezzanine loan will have a hard lockbox. Since no cash will flow to a subsequent encumbering lender, most mortgagees would be dissuaded from loaning funds with the security of a second mortgage.
- Until securitization sometimes second mortgage is required for just this reason.
- The Special Purpose Entity (SPE) organizational documents will prohibit such a mortgage. Any reputable lender will ask for opinion of counsel that the mortgage is authorized. Reputable counsel would obtain copies of the organizational documents before rendering an opinion and the lender might request such documents as well.
- Sometimes the secured lender is given special member status where its vote/consent is required for specified actions such as the grant of subordinate liens.
- Violation of the entity’s organizational documents would subject the grant of a subordinate mortgage to challenge as an ultra vires act.
- The securitized first mortgage will make the grant of additional liens on the property an event of default. No reputable mortgagee would lend money with the risk of an immediate default under the first mortgage. The risk of such a default might also deter the borrower from placing the mortgage on the property.
- The granting of an additional lien will likely trigger liability under the non-recourse carveouts under the first and mezzanine loan documents. Fraud is typically a carve-out from the non-recourse provisions of the documents and violation of the SPE covenants may also be a carve-out. There may be an express carveout for voluntary liens. Assuming the entity/individual guaranteeing the non-recourse carveouts (typically entities or individuals affiliated with both the mortgage borrower and the mezzanine borrower) has assets available to satisfy claims, the triggering of a significant non-recourse carveout liability is a substantial deterrent. Payments under the carveouts would also provide a source of repayment to the mezzanine lender.

6. Could a lender inherit borrower liabilities for say, environmental remediation?

Yes, but some factors that mitigate the risk:

- Mezzanine lenders typically require Phase I Environmental reports and further testing if the Phase I indicates a problem.
- Prior to foreclosing on the ownership interest in the property owner, the mezzanine lender would update its initial Phase I.
It is common to obtain for the benefit of the Mezzanine Lender as well as the First Mortgagee an environmental indemnification. The value of this will depend upon the creditworthiness of the indemnifying party.

The SPE covenants will limit the activities the entity may engage in which if honored would limit the obligations that a mezzanine lender would assume. Violation of the SPE covenants would trigger personal recourse liability in those situations when the SPE covenants are carve-outs to the non-recourse provisions.

The lender protections against environmental liabilities in a first mortgage situation may be overrated since to sell the property with significant environmental problems is likely to result in significant loss. Most often the lender assesses the environmental liability and may elect to take title and cure the problem before selling. The mezzanine lender may similarly elect to take title and cure the problem if that makes economic sense.

The mezzanine lender assumes ownership of stock/membership interest/partnership interests in a SPE that holds title to potentially contaminated real estate. By avoiding any action that would cause a court “to pierce the corporate veil” (a difficult standard for a plaintiff to overcome) the mezzanine lender’s sole exposure is its investment in the SPE. The Lender can be further insulated by transferring ownership of the real estate SPE to an SPE created by the mezzanine lender.

7. Are there similar types of structural risks introduced by this structure that should be part of the criteria for determining whether mortgage loan treatment is appropriate?

You have identified the three major risks:

- Certainty of ability to foreclose
- Possibility that junior mortgages or liens could encumber the property with no ability to foreclose out the mortgages or liens
- Liability for entity level obligations

There are some distinct advantages:

- A mezzanine lender can gain control over the property in say 30 days as compared to years in judicial foreclosure states.
- The lockbox structure, atypical in a classic second mortgage, prevents the borrower from milking the property and diverting cash.
- The SPE structure, atypical with second mortgages prior to the advent of securitized transactions, limits the activities of the borrower to the single mortgaged property making it less likely that other activities or properties adversely affect the mortgaged property.
- The Intercreditor Agreement with the First Mortgagee is likely to be more advantageous than any agreement reached by a second mortgagee. Cure rights can frequently be obtained.
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Statutory Issue Paper No. 114

Accounting for Derivative Instruments and Hedging Activities

STATUS
Finalized October 16, 2001

Type of Issue
Common Area

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principles No. 31—Derivative Instruments (SSAP No. 31) contains guidance on accounting for derivative instruments. The applicable GAAP guidance is included in Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities (FAS 133), FAS 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 an amendment of FASB Statement No. 133 (FAS 137), FAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities—an amendment of FASB Statement No. 133 (FAS 138) and their related Emerging Issues Task Force Issues.

2. The purpose of this issue paper is to address the concepts outlined in FAS 133 and establish a comprehensive statutory accounting model for derivative instruments. This issue paper will also reassess the provisions of SSAP No. 31. The result will be a new SSAP, which will supersede SSAP No. 31. The purpose also includes development of an accounting model for derivatives that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION:

3. SSAP No. 31 is superseded in its entirety by the conclusions outlined in this issue paper.

4. This issue paper addresses the recognition of derivatives and measurement of derivatives used in:
   a. Hedging transactions;
   b. Income generation transactions; and
   c. Replication transactions

Definitions (for purposes of this issue paper)

5. “Derivative instrument” means an agreement, option, instrument or a series or combination thereof:
   a. To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or
   b. That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

6. Derivative instruments include, but are not limited to; options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements or instruments substantially similar thereto or any series or combination thereof.
a. “Caps” are option contracts in which the cap writer (seller), in return for a premium, agrees to limit, or cap, the cap holder’s (purchaser) risk associated with an increase in a reference rate or index. For example, in an interest rate cap, if rates go above a specified interest rate level (the strike price or the cap rate), the cap holder is entitled to receive cash payments equal to the excess of the market rate over the strike price multiplied by the notional principal amount. Because a cap is an option-based contract, the cap holder has the right but not the obligation to exercise the option. If rates move down, the cap holder has lost only the premium paid. A cap writer has virtually unlimited risk resulting from increases in interest rates above the cap rate;

b. “Collar” means an agreement to receive payments as the buyer of an option, cap or floor and to make payments as the seller of a different option, cap or floor;

c. “Floors” are option contracts in which the floor writer (seller), in return for a premium, agrees to limit the risk associated with a decline in a reference rate or index. For example, in an interest rate floor, if rates fall below an agreed rate, the floor holder (purchaser) will receive cash payments from the floor writer equal to the difference between the market rate and an agreed rate multiplied by the notional principal amount;

d. “Forwards” are agreements (other than a futures) between two parties that commit one party to purchase and the other to sell the instrument or commodity underlying the contract at a specified future date. Forward contracts fix the price, quantity, quality, and date of the purchase and sale. Some forward contracts involve the initial payment of cash and may be settled in cash instead of by physical delivery of the underlying instrument;

e. “Futures” are standardized forward contracts traded on organized exchanges. Each exchange specifies the standard terms of futures contracts it sponsors. Futures contracts are available for a wide variety of underlying instruments, including insurance, agricultural commodities, minerals, debt instruments (such as U.S. Treasury bonds and bills), composite stock indices, and foreign currencies;

f. “Options” are contracts that give the option holder (purchaser of the option rights) the right, but not the obligation, to enter into a transaction with the option writer (seller of the option rights) on terms specified in the contract. A call option allows the holder to buy the underlying instrument, while a put option allows the holder to sell the underlying instrument. Options are traded on exchanges and over the counter;

g. “Swaps” are contracts to exchange, for a period of time, the investment performance of one underlying instrument for the investment performance of another underlying instrument, typically without exchanging the instruments themselves. Swaps can be viewed as a series of forward contracts that settle in cash rather than by physical delivery. Swaps generally are negotiated over-the-counter directly between the dealer and the end user. Interest rate swaps are the most common form of swap contract. However, foreign currency and commodity swaps also are common;

h. “Warrants” are instruments that give the holder the right to purchase an underlying financial instrument at a given price and time or at a series of prices and times outlined in the warrant agreement. Warrants may be issued alone or in connection with the sale of other securities, for example, as part of a merger or recapitalization agreement, or to facilitate divestiture of the securities of another business entity.

7. “Firm commitment” is an agreement with an unrelated party, binding on both parties and expected to be legally enforceable, with the following characteristics:
a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity’s functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield;

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable; and

c. For investments in subsidiary, controlled, and affiliated entities (as defined by SSAP No. 46 – Investments in Subsidiary, Controlled, and Affiliated Entities) and investments in limited liability companies (as defined by SSAP No. 48 – Joint Ventures, Partnerships and Limited Liability Companies) it must be probable that acquisition will occur within a reasonable period of time.

8. A hedging transaction is defined as a derivative transaction which is entered into and maintained to reduce:

   a. The risk of a change in the fair value or cash flow of assets and liabilities which the reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence; or

   b. The currency exchange rate risk or the degree of exposure as to assets and liabilities which a reporting entity has acquired or incurred or has a firm commitment to acquire or incur or for which the entity has forecasted acquisition or incurrence.

9. “Income generation transaction” is defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

10. “Replication (Synthetic Asset) transaction” is a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

11. “Forecasted transaction” is a transaction that is expected to occur for which there is no firm commitment. Because no transaction or event has yet occurred and the transaction or event when it occurs will be at the prevailing market price, a forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices.

12. An “underlying” is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

**Embedded Derivative Instruments**

13. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded
derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Impairment

14. This issue paper adopts the impairment guidelines established by SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5) for the underlying financial assets or liabilities.

Recognition and Measurement of Derivatives Used in Hedging Transactions

15. Derivative instruments represent rights or obligations that meet the definitions of assets (SSAP No. 4—Assets and Nonadmitted Assets) or liabilities (SSAP No. 5) and shall be reported in financial statements. In addition, derivative instruments also meet the definition of financial instruments as defined in SSAP No. 27—Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk, Financial Instruments with Concentrations of Credit Risk and Disclosures about Fair Value of Financial Instruments (SSAP No. 27). Should the cost basis of the derivative instrument be undefined (i.e., no premium is paid), the instrument shall be disclosed in accordance with paragraphs 8 through 10 of SSAP No. 27. Derivative instruments are admitted assets to the extent they conform to the requirements of this issue paper.

16. Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. Derivative instruments used in hedging transactions that do not meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

17. Entities shall not bifurcate the effectiveness of derivatives. A derivative instrument is either classified as an effective hedge or an ineffective hedge. Entities must account for the derivative using fair value accounting if it is deemed to be ineffective. Entities may redesignate a derivative in a hedging relationship even though the derivative was used in a previous hedging relationship that proved to be ineffective. An entity shall prospectively discontinue hedge accounting for an existing hedge if any one of the following occurs:

a. Any criterion in paragraphs 20 through 23 is no longer met;

b. The derivative expires or is sold, terminated, or exercised (impact recorded as realized gains or losses or, for effective hedges of firm commitments or forecasted transactions, in a manner that is consistent with the hedged transaction – see paragraph 18);

c. The entity removes the designation of the hedge; or

d. The derivative is deemed to be impaired in accordance with paragraph 14. A permanent decline in a counterparty’s credit quality/rating is one example of impairment required by paragraph 14, for derivatives used in hedging transactions.

18. For those derivatives which qualify for hedge accounting, the change in the carrying value or cash flow of the derivative shall be recorded consistently with how the changes in the carrying value or cash flow of the hedged asset, liability, firm commitment or forecasted transaction are recorded.
Hedge Designations

19. An entity may designate a derivative instrument as hedging the exposure to:

a. Changes in the fair value of an asset or a liability or an identified portion thereof that is attributable to a particular risk. This type of hedge can be utilized regardless of whether the hedged asset or liability is recorded in the financial statements at fair value;

b. Variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction; or

c. Foreign currency exposure. Specific examples include a fair value or cash flow hedge of a firm commitment or financial instrument.

Fair Value Hedges

20. Fair value hedges qualify for hedge accounting if all of the following criteria are met:

a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship must be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship;

c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80, Accounting for Futures Contracts (FAS 80). As a result, highly effective describes a fair value hedging relationship where the change in the fair value of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the fair value of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B;

d. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof); and

e. If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk.

Cash Flow Hedges

21. Cash flow hedges qualify for hedge accounting if all of the following criteria are met:
a. At inception of the hedge, the formal documentation requirements of paragraph 26 are met;

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship shall be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship; and

c. The term highly effective has the same meaning as the notion of high correlation as utilized in FAS No. 80. As a result, highly effective describes a cash flow hedging relationship where the change in the cash flows of the derivative hedging instrument is within 80 to 125 percent of the opposite change in the cash flows of the hedged item attributable to the hedged risk. It shall also apply when an R-squared of .80 or higher is achieved when using a regression analysis technique. Further guidance on determining effectiveness can be found within Exhibit A and B.

Hedging Forecasted Transactions

22. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable. An assessment of the likelihood that a forecasted transaction will take place should not be based solely on management's intent because intent is not verifiable. The transaction's probability should be supported by observable facts and the attendant circumstances. Consideration should be given to the following circumstances in assessing the likelihood that a transaction will occur:

i. The frequency of similar past transactions;

ii. The financial and operational ability of the entity to carry out the transaction;

iii. Substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity);

iv. The extent of loss or disruption of operations that could result if the transaction does not occur; and

v. The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering).

The term probable requires a significantly greater likelihood of occurrence than the phrase more likely than not. In addition, both the length of time until a forecasted transaction is projected to occur and the quantity of the forecasted transaction are considerations in determining probability. Other factors being equal, the more distant a forecasted transaction is, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be needed to support an assertion that
it is probable. For example, a transaction forecasted to occur in five years may be less likely than a transaction forecasted to occur in one year. However, forecasted interest payments for the next 20 years on variable-rate debt typically would be probable if supported by an existing contract. Additionally, other factors being equal, the greater the physical quantity or future value of a forecasted transaction, the less likely it is that the transaction would be considered probable and the stronger the evidence that would be required to support an assertion that it is probable. For example, less evidence generally would be needed to support forecasted investments of $100,000 in a particular month than would be needed to support forecasted investments of $950,000 in that month by an entity, even if its investments have averaged $950,000 per month for the past 3 months.

A forecasted transaction that is expected to occur with 2 months of the original forecasted date (or time frame) may still be considered probable. If the transaction will not occur until greater than 2 months after the original forecasted date, it is no longer probable and will be accounted for as per the following paragraph.

If a forecasted transaction is determined to no longer be probable per the standards above, hedge accounting shall cease immediately and any deferred gains or losses on the derivative must be recognized in unrealized gains or losses. If an entity demonstrates a pattern of determining that hedged forecasted transactions probably will not occur, such action would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. Accordingly, hedging of forecasted transactions will no longer be permitted by that entity.

c. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient.

d. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the designated benchmark interest rate, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (4) the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must specifically be identified as part of the designation and documentation at the inception of the hedging relationship. An entity may not designate prepayment risk as the risk being hedged.
Foreign Currency Hedges

23. For foreign currency hedges, this issue paper adopts paragraphs 36 through 42 (except for last sentence of paragraph 38) of FAS No. 133 and paragraphs 4b. through 4o. of FAS No. 138 which amend FAS No. 133.

Hedge Effectiveness

24. The measurement of hedge effectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 26.

25. The gain or loss on a derivative designated as a cash flow hedge and assessed to be effective is reported consistently with the hedged item. If an entity’s defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in Exhibit B), that excluded component of the gain or loss shall be recognized as an unrealized gain or loss. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in unrealized gains or losses. Time value is equal to the fair value of the option less its intrinsic value.

Documentation Guidance

26. At inception of the hedge, documentation must include:

   a. A formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value or variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness;

   b. An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 of FAS 133;

   c. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions; and

   d. A description of the reporting entity's methodology used to verify that opening transactions do not exceed limitations promulgated by the state of domicile.

27. For all derivatives terminated, expired, or exercised during the year:

   a. Signature of approval, for each instrument, by person(s) authorized, either by the entity's board of directors or a committee authorized by the board, to approve such transactions;

   b. A description, for each instrument, of the nature of the transaction, including:

      i. The date of the transaction;
ii. A complete and accurate description of the specific derivative, including description of the underlying securities, currencies, rates, indices, commodities, derivatives, or other financial market instruments;

iii. Number of contracts or notional amount;

iv. Date of maturity, expiry or settlement;

v. Strike price, rate or index (termination price for futures contracts);

vi. Counterparty, or exchange on which the transaction was traded; and

vii. Consideration paid or received, if any, on termination.

c. Description of the reporting entity's methodology to verify that derivatives were effective hedges; and

d. Identification of any derivatives that ceased to be effective as hedges.

28. For derivatives open at quarter-end:

a. A description of the methodology used to verify the continued effectiveness of hedges;

b. An identification of any derivatives which have ceased to be effective as hedges;

c. A description of the reporting entity's methodology to determine fair values of derivatives;

d. Copy of Master Agreements, if any, where indicated on Schedule DB Part E Section 1.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

General

29. Income generation transactions are defined as derivatives written or sold to generate additional income or return to the reporting entity. They include covered options, caps, and floors (e.g., a reporting entity writes an equity call option on stock that it already owns).

30. Because these transactions require writing derivatives, they expose the reporting entity to potential future liabilities for which the reporting entity receives a premium up front. Because of this risk, dollar limitations and additional constraints are imposed requiring that the transactions be "covered" (i.e., offsetting assets can be used to fulfill potential obligations). To this extent, the combination of the derivative and the covering asset works like a reverse hedge where an asset owned by the reporting entity in essence hedges the derivative risk.

31. As with derivatives in general, these instruments include a wide variety of terms regarding maturities, range of exercise periods and prices, counterparties, underlying instruments, etc.

32. The principal features of income generation transactions are:

a. Premium received is initially recorded as a deferred liability;

b. The accounting of the covering asset or underlying interest controls the accounting of the derivative. The covering asset/underlying interest is accounted at either fair value (e.g., common stocks) or (amortized) cost (e.g., bonds);

c. The gain/loss on termination of the derivative is a capital item. For life insurance companies, it shall be subject to IMR treatment if interest rate related;

d. For options which are exercised, the remaining premium shall adjust the proceeds (cost) associated with the exercise resulting in no explicit gain or loss reported for the derivative itself.
33. The principal features of written fixed income covered call options are:

a. The general approach is to value at cost (i.e., consideration received) without amortization over the life of the contract if the original duration is less than one year, otherwise carry at amortized cost;

b. An alternative to the general approach combines the accounting of the written option with the covering asset and then uses standard accounting for callable bonds (yield to worst amortization) on the adjusted asset. This method prevents the possibility of future loss recognition upon exercise while at the same time providing recognition of the income feature of the option over time. This approach would appear most relevant for longer-lived covered European call options, which are in substance like callable bonds;

c. For life insurance companies, the gain or loss flows through the IMR if the covering asset or underlying interest is subject to the IMR using callable bond rules to determine the remaining life;

d. Reporting entities are responsible for timely recognition of any probable losses that may occur as a result of the strategy. If the exercise price is below the covering asset's book value, the asset shall be evaluated for write down or disclosure treatment in accordance with SSAP No. 5. All relevant factors such as whether the option is currently exercisable, the fair value of the bond relative to its exercise price, to what extent the statement value of the option premium offsets any loss on the asset, or how any IMR transaction on exercise would affect unassigned funds (surplus) and income shall be considered.

34. Written fixed income covered call options shall be accounted for as follows:
### STATUS OF OPTION

<table>
<thead>
<tr>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT FAIR VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Open</strong></td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value. (Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</td>
</tr>
<tr>
<td></td>
<td>Alternatively, attach premium to covering asset and amortize (under yield to worse scenario) using standard callable bond accounting.</td>
</tr>
<tr>
<td><strong>Closed – Expired</strong></td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR, if applicable.</td>
</tr>
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<td>(1)</td>
<td></td>
</tr>
<tr>
<td><strong>Closed – Exercised</strong></td>
<td>Adjust disposition proceeds. (Include in capital gain/loss of disposed asset.)</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
</tr>
<tr>
<td>(1)</td>
<td></td>
</tr>
<tr>
<td><strong>Closed – Terminated</strong></td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow through IMR, if applicable.</td>
</tr>
<tr>
<td>(1)</td>
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</tbody>
</table>

**NOTE:**

(1) If premium is attached to covering asset, the accounting treatment for the covering asset applies.

**Written Covered Put Options**

35. The principal features of written covered put options are:
a. The accounting for the underlying interest instead of the covering asset governs the accounting of the written put while it is open. For example, if a reporting entity wrote a put requiring it to purchase a certain common stock (underlying interest) at a specific price, the reporting entity might cover that option by holding cash or cash equivalents (covering asset). The accounting for the common stock would govern the accounting of the option in this case;
b. As with covered call writing for life insurance companies, gain/loss on termination may be subject to IMR over the remaining life of the underlying interest;
c. As with covered call writing, entities writing put options for income generation purposes are responsible for timely recognition of any probable losses that may occur as a result of the strategy.

36. Written covered put options shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>UNDERLYING INTEREST VALUED AT AMORTIZED COST</th>
<th>UNDERLYING INTEREST VALUED AT FAIR VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value.</td>
<td>Changes in fair value recorded as</td>
</tr>
<tr>
<td></td>
<td></td>
<td>unrealized adjustments to</td>
</tr>
<tr>
<td></td>
<td></td>
<td>unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td>Closed – Expired</td>
<td>Premium received recognized as realized</td>
<td>Premium received recognized as</td>
</tr>
<tr>
<td></td>
<td>capital gain.</td>
<td>realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Gain from expiration to flow through IMR,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>if applicable.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Adjust acquisition cost by premium received.</td>
<td>Adjust acquisition cost by premium</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital</td>
<td>Recognize net amount as realized</td>
</tr>
<tr>
<td></td>
<td>gain/loss.</td>
<td>capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain or loss from disposition to flow</td>
<td></td>
</tr>
<tr>
<td></td>
<td>through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Written Fixed Income Caps and Floors

37. The principal features of written fixed income caps and floors are:

a. The value of the premium received shall be amortized into income over the life of the contract. For caps and floors, where the entity is selling off possible excess interest/income, the value of the covering asset is not relevant;
b. Gain/loss may be subject to IMR. The expected maturity would be the derivative contract's maturity.

38. Written fixed income caps and floors shall be accounted for as follows:

<table>
<thead>
<tr>
<th>STATUS OF OPTION</th>
<th>COVERING ASSET VALUED AT AMORTIZED COST</th>
<th>COVERING ASSET VALUED AT FAIR VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open</td>
<td>Record premium as deferred liability.</td>
<td>Record premium as deferred liability.</td>
</tr>
<tr>
<td></td>
<td>Carry at amortized value.</td>
<td>Changes in fair value recorded as unrealized adjustments to unassigned funds (surplus) – gain/loss.</td>
</tr>
<tr>
<td></td>
<td>(Alternatively carry at consideration received if original duration is less than 1 year to maturity.)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Amortize over life of contract to produce constant yield.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Record any interest expense as “Other Investment Income” – negative value.</td>
<td></td>
</tr>
<tr>
<td>Closed – Matured</td>
<td>Would usually mature at zero amortized value.</td>
<td>Premium received recognized as realized capital gain.</td>
</tr>
<tr>
<td></td>
<td>Any remaining unamortized value recognized as ordinary income through a final amortization adjustment.</td>
<td></td>
</tr>
<tr>
<td>Closed – Exercised</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Closed – Terminated</td>
<td>Recognize net amount as realized capital gain/loss.</td>
<td>Recognize net amount as realized capital gain/loss.</td>
</tr>
<tr>
<td></td>
<td>Gain/loss on termination to flow through IMR, if applicable.</td>
<td></td>
</tr>
</tbody>
</table>

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

39. Replication (Synthetic Asset) transaction means a derivative transaction entered into in conjunction with other investments in order to reproduce the investment characteristics of otherwise permissible investments. A derivative transaction entered into by an insurer as a hedging or income generation transaction shall not be considered a replication (synthetic asset) transaction.

40. Any premium paid or received shall be carried as an asset or liability on the balance sheet (Aggregate Write-in for Invested Asset (or) Liability). Premiums paid or received on the replication (synthetic asset) derivative should be amortized into investment income or expense until the exercise, termination or maturity date of the derivative.
41. If the replication (synthetic asset) transaction would be carried at amortized cost and the cash instrument used is carried at amortized cost, then the derivative used should be carried at amortized cost. The derivative may be valued at fair value when both the replication (synthetic asset) and the cash instrument are valued at amortized cost. This is consistent with the alternative valuation methods available for hedges. If the replication (synthetic asset) transaction would be carried at fair value and/or the cash instrument used is carried at fair value, then the derivative used should be carried at fair value.

<table>
<thead>
<tr>
<th>(a)</th>
<th>(b)</th>
<th>(c)</th>
<th>(d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the Replication (Synthetic Asset) is Valued at:</td>
<td>And Cash Instrument(s) Used is (are) Valued at:</td>
<td>The Derivative is Valued at:</td>
<td>Alternative Derivative Value Basis:</td>
</tr>
<tr>
<td>1. Amortized Cost</td>
<td>Amortized Cost</td>
<td>Amortized Cost</td>
<td>Fair value</td>
</tr>
<tr>
<td>2. Fair value</td>
<td>Fair value</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
<tr>
<td>3. Amortized Cost</td>
<td>Fair value</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
<tr>
<td>4. Fair value</td>
<td>Amortized Cost</td>
<td>Fair value</td>
<td>N/A</td>
</tr>
</tbody>
</table>

42. In the case of No. 3 in the chart above, the fair values for the cash instrument and derivative, when added together, shall not exceed the replication (synthetic asset) statement value. If this does occur, the excess shall reduce the fair value of the derivative.

43. If the replication (synthetic asset) transaction involves the exchange of interest related cash flows (default free assets), then the cash flows should be accrued as investment income. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The interest income portion should be accrued as investment income.

44. If the derivative is carried at fair value, the periodic change in the fair value should be recorded as an unrealized gain or loss adjustment to surplus until the transaction is terminated. If the replication (synthetic asset) transaction involves the exchange of total return or change in index cash flows, then the cash flows should be segregated between interest income and fair value (equity) changes. The fair value (equity) change should be recognized as a deferred asset/liability until the termination of the contract. Gains or losses on the derivative at termination or sale should be recognized as realized.

Disclosure Requirements

45. Reporting entities shall disclose the following for all derivative contracts used:

   a. General disclosures:
      i. A description of the reporting entity’s objectives for using derivatives, i.e., hedging, income generation or replication;
      ii. A description of the context needed to understand those objectives and its strategies for achieving those objectives;
      iii. The description for hedging objectives shall identify the category, e.g., fair value hedges, cash flow hedges, or foreign currency hedges, and for all objectives, the type of instrument(s) used;
      iv. A description of the accounting policies for derivatives including the policies for recognizing (or reasons for not recognizing) and measuring the derivatives used, and when recognized, where those instruments and related gains and losses are reported;
v. The net gain or loss recognized in unrealized gains or losses during the reporting period representing the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness; and
vi. The net gain or loss recognized in unrealized gains or losses during the reporting period resulting from derivatives that no longer qualify for hedge accounting.

b. Disclosures by type of instrument outstanding, e.g., call options, floors, etc.:
   i. Notional or contract amounts;
   ii. Carrying and fair values; and
   iii. A discussion of the market risk, credit risk, and cash requirements of the derivatives.

c. For derivatives held for other than hedging purposes in addition to a and b above:
   i. Average fair value of the derivatives during the reporting period together with the related end-of-period fair value distinguishing between assets and liabilities;
   ii. Net gains or losses detailed by class, business activity or other category that is consistent with the management of those activities and where the net gains or losses are reported.

d. The financial statements shall disclose details of covered items and/or written transactions to allow evaluation of cash flow implications for all written covered options used for income generation.

e. For derivatives accounted for as cash flow hedges of a forecasted transaction, disclose:
   i. The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments; and
   iii. The amount of gains and losses classified in unrealized gains/losses related to cash flow hedges that have been discontinued because it was no longer probable that the original forecasted transactions would occur by the end of the originally specified time period or within 2 months of that date.

f. The disclosure requirements of 45 a, 45 b, and 45 c shall be included in the Annual Statement. Refer to the preamble for further discussion regarding interim disclosure requirements. The disclosure requirements of paragraphs 45 a through and 45 e shall be included in the annual audited statutory financial reports. Paragraph 55 of the Preamble states that disclosures made within specific schedules or exhibits to the Annual Statement need not be duplicated in a separate note.

Effective Date

46. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2002.
DISCUSSION

47. The purpose of this issue paper is two-fold. First, to provide a comprehensive source on accounting for derivatives used in hedges, income generation and replication transactions. Second, to address the GAAP guidance that has been issued subsequent to the finalization of SSAP No. 31. In general, this issue paper adopts the framework established by FAS No. 133 for fair value and cash flow hedges, but not its technical guidance (discussed further in subsequent paragraphs). This issue paper adopts the provisions of FAS No. 133 and 138 related to foreign currency hedges. With the exception of guidance specific to foreign currency hedges and amendments specific to refining the hedging of interest rate risk (under FAS 138, the risk of changes in the benchmark interest rate would be the hedged risk), this issue paper rejects FAS No. 137 and 138 as well as the various related Emerging Issues Task Force interpretations (complete listing found in RELEVANT LITERATURE section of this issue paper). It should be noted that the conclusions reached in this issue paper are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this issue paper are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.

Definitions

48. This issue paper defines a derivative instrument somewhat differently than FAS No. 133. The Statutory Accounting Principles (SAP) working group evaluated the FAS No. 133 definition and found that it was inconsistent with the manner in which derivatives are regulated in the insurance industry. While FAS 133 defines derivatives in the context of the characteristics contained in an instrument, the working group concluded that a definition based upon the legal form/contractual rights and obligations is more relevant to statutory reporting. As a result, the definition of a derivative in paragraph 5 of this issue paper is not intended to include life contracts, accident and health contracts, property and casualty contracts and deposit-type contracts as defined within SSAP No. 50 – Classifications and Definitions of Insurance or Managed Care Contracts in Force. Some of these contracts may be considered derivatives under the FAS No. 133 definition.

Embedded Derivative Instruments

49. FAS No. 133 requires that a contract containing an embedded derivative be accounted for separately from the host contract unless the embedded instrument is clearly and closely related to economic characteristics and risks of the host contract. This issue paper rejects that requirement and stipulates that such embedded derivatives shall not be accounted for separately from the host contract. The SAP working group does not believe this provision is applicable to insurance companies as evidenced by the FASB’s difficulty in providing guidance for certain life contracts that include features not associated with insured events. In addition, the SAP working group believes the insurance specific definition of a derivative used in paragraph 5 of this issue paper excludes a majority of the contracts that would include embedded derivatives.

Impairment

50. This issue paper adopts the impairment guidelines of SSAP No. 5. The application of such shall be consistent with the hedged or replicated asset. For instance, a derivative used in a hedging transaction would follow the impairment guidelines for the hedged asset, whereas a derivative used in a replication transaction would follow the impairment guidelines for the asset it is replicating. For derivatives used in hedging transactions one example of an impairment in accordance with SSAP No. 5 would be the permanent decline in the counterparty’s credit rating/quality. This example is not applicable to replication transactions as a reporting entity might be try to replicate a similar scenario.
Recognition and Measurement of Derivatives Used in Hedging Transactions

51. The SAP working group believes that a prudent use of derivatives can be an important tool in a sound risk management strategy. Risk management is the practice of defining the risk level an entity desires, identifying the risk level it currently has, and using derivative or other financial instruments to adjust the actual risk level to the desired risk level. Therefore, this issue paper allows holders of derivative instruments used in hedging transactions that meet the criteria of an effective hedge to value and report the derivative in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). This would allow derivatives that effectively hedge assets valued at amortized cost to also be valued at amortized cost.

52. This treatment is a dramatic departure from the requirements of FAS No. 133 in which all derivatives are valued and reported at fair value. This is possible for GAAP accounting because of the existence of FAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS No. 115) which requires a majority of GAAP (debt and equity) investments to be recorded at fair value. Therefore, the GAAP model is consistent within its framework to value many financial instruments at fair value. FAS No. 115 has been rejected by several SSAPs as regulators have concluded that the fluctuations of fair value from period to period violates the concepts of conservatism and consistency (further discussion can be found within Issue Papers No. 26, 30, 32 and 43). The result of rejecting FAS No. 115 results in a mixed valuation model in which certain financial instruments are valued at cost while some others are recognized at fair value (e.g., non-impaired bonds are recorded at amortized cost, equity instruments valued at fair value, real estate valued at cost or fair value depending upon management’s intent). The SAP working group does not believe it is appropriate to value all derivatives at fair value if the assets they are intended to hedge are not also recognized at fair value. Under the FAS No. 133 model, an insurer cannot utilize hedge accounting for debt securities that the entity has the positive intent and ability to hold to maturity as such securities are classified as held-to-maturity securities and reported at amortized cost. This is due to the fact that fluctuations in fair value of the derivative would not offset the fluctuations in fair value of the debt security as the debt security is recorded at amortized cost and there is no impact on surplus for changes in its fair value. By utilizing the concept of emulating valuation of the hedged assets and derivatives adopted in this issue paper consistency is achieved within the mixed valuation model. The concept of emulating valuation also supports the conservatism concept of statutory accounting in that using the amortized values and unrealized gains or losses, derivatives used in hedging should be protected from significant temporary gains from being incorporated into earnings. Further, the conservatism concept is supported in permanent losses by application of the impairment requirement.

53. This issue paper also adopts a provision to recognize the changes in fair value of a derivative that does not meet the criteria for hedge accounting to be recorded as unrealized gains or losses. SSAP No. 31 requires these changes to be recognized currently in earnings. The SAP working group believes the SSAP No. 31 treatment is inconsistent with similar guidance for equity investments in that the earnings process has not been completed.

Hedge Designations

54. This issue paper adopts the hedge designation framework established in FAS No. 133 in that entities may designate a derivative instrument as hedging the exposure to changes in fair value, variability in expected future cash flow or foreign currency exposures. This decision was made so that statutory accounting would be consistent for entities that must also conform to the documentation requirements of FAS No. 133.

55. This issue paper allows entities to hedge a portfolio of similar assets or similar liabilities but does not advocate hedging of an entire portfolio with dissimilar risks (referred to as macro hedging). If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual
liabilities must share the same risk exposure for which they are designated as being hedged. In a fair
d value hedge, the change in fair value attributable to the hedged risk for each individual item in a hedged
portfolio must be expected to respond in a generally proportionate manner to the overall change in fair
value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a
hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in
the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to
be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the
change in fair value attributable to the hedged risk for individual items in the portfolio would range from
7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be
hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type,
loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest
rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected
prepayment performance in varying interest rate scenarios.

56. To qualify for hedge accounting, this issue paper requires that fair value, cash flow and foreign
currency hedges must be highly effective in achieving its offsetting objectives. The term “highly
effective” is specifically defined within this issue paper unlike FAS No. 133. The SAP working group
defined this term so that consistent application of effectiveness could be attained. Additionally, the issue
paper rejects the FAS No. 133 concept of identifying and separately accounting for the effective and
ineffective portions of a single hedge. This issue paper instructs entities not to bifurcate effectiveness; an
entity either has an effective hedge (must use hedge accounting) or an ineffective hedge (must use fair
value accounting). Again, deviation from FAS No. 133 was made for consistency.

57. The provisions of FAS No. 133 and 138 related to hedging foreign currency are adopted in this
issue paper as they do not violate the principles that define the Statement of Concepts.

Documentation

58. This issue paper adopts documentation guidance, which is a combination of the requirements of
FAS No. 133 and SSAP No. 31. None of the requirements of SSAP No. 31 were removed and the FAS
No. 133 requirements were added so that entities that also complete GAAP statements would not have to
maintain separate documentation.

Recognition and Measurement of Derivatives Used in Income Generation Transactions

59. This issue paper retains the requirements of SSAP No. 31 for income generation transactions.
This guidance is needed for those entities who wish to write or sell derivatives in an attempt to generate
additional income and therefore do not use these types of derivatives to hedge risk exposures.

Recognition and Measurement of Derivatives Used in Replication (Synthetic Asset) Transactions

60. The guidance included for replication transactions was adopted as “NAIC Preferred Accounting
Treatment” by the Emerging Accounting Issues working group on June 7, 1999. Inclusion in this issue
paper of the preferred accounting guidance for replications formalizes its position within the Statutory
Hierarchy.

Disclosures

61. This issue paper adopts disclosure requirements that represent a combination of the provisions of
FAS No. 133 and SSAP No. 31.
Drafting Notes/Comments
- The issue of disclosing derivatives embedded within financial assets will be addressed by the Invested Asset (E) Working Group.
- The issue of accounting for and the reporting of insurance derivatives (used in hedging insurance exposures) will be addressed by the Insurance Securitization (E) Working Group.
- The general reference to FAS No. 133 and 138 for foreign currency hedges will be replaced with the specific language in the SSAP once the staff has an opportunity to meld the two pronouncements together.
- The reporting guidance referred to in paragraph 18 will be refined by the FAS No. 133 Subgroup after further deliberation.
- The language specific to Insurance Futures and Insurance Futures Options has not been included in this issue paper due to the lack of activity in this market.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting
62. Statement of Statutory Accounting Principles No. 31—Derivative Instruments provides the current statutory guidance for most derivative transactions.

63. The Emerging Accounting Issues working group adopted as NAIC preferred accounting treatment the conclusions reached in this issue paper for replication transactions. The following was taken from the June 7, 1999 minutes of the working group:

Mr. Clark reported that the working group had reached a tentative consensus on the issue of accounting for replication transactions during an interim conference call on May 12, 1999. This consensus was exposed on the NAIC website after the 1999 Spring National Meeting, and the NAIC staff received no comments on it.

Mr. Medley questioned whether the word “consideration” could be used instead of “premium” as shown on Attachment A Part (b) (see attachment 4 to the 5/12/99 conference call minutes). Maria Avila (Northwestern Mutual Life), on behalf of interested parties, indicated that the change would not modify the intent or conclusion of the proposal. Mr. Johnson made a motion to finalize the tentative consensus, as modified, and grant the proposal preferred NAIC accounting treatment. Mr. Ford seconded the motion. The working group unanimously adopted the motion.

Mr. Clark stressed that this issue falls under the old working group rules and, thus, the working group can only grant preferred NAIC accounting treatment. This issue will also be addressed by the Codification of Statutory Accounting Principles working group when SFAS No. 133, Accounting for Derivative Accounting Principles working group when SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities is reviewed under the maintenance process.

Generally Accepted Accounting Principles
64. FAS 133 provides the following guidance (the language shown in italics has been amended by FAS No. 137 and 138):

INTRODUCTION
1. This Statement addresses the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities.

2. Prior to this Statement, hedging activities related to changes in foreign exchange rates were addressed in FASB Statement No. 52, Foreign Currency Translation. FASB Statement No. 80, Accounting for Futures Contracts, addressed the use of futures contracts in other hedging activities. Those Statements addressed only certain derivative instruments and differed in the criteria required for hedge accounting. In addition, the Emerging Issues Task Force (EITF) addressed the accounting for various hedging activities in a number of issues.
3. In developing the standards in this Statement, the Board concluded that the following four fundamental decisions should serve as cornerstones underlying those standards:

   a. Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.

   b. Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value, and adjustments to the carrying amount of hedged items should reflect changes in their fair value (that is, gains or losses) that are attributable to the risk being hedged and that arise while the hedge is in effect.

   c. Only items that are assets or liabilities should be reported as such in financial statements.

   d. Special accounting for items designated as being hedged should be provided only for qualifying items. One aspect of qualification should be an assessment of the expectation of effective offsetting changes in fair values or cash flows during the term of the hedge for the risk being hedged.

Those fundamental decisions are discussed individually in paragraphs 217–231 of Appendix C.

4. This Statement standardizes the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value. If certain conditions are met, an entity may elect to designate a derivative instrument as follows:

   a. A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge)

   b. A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge)

   c. A hedge of the foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

This Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk or (b) the earnings effect of the hedged forecasted transaction. Appendix A provides guidance on identifying derivative instruments subject to the scope of this Statement and on assessing hedge effectiveness and is an integral part of the standards provided in this Statement. Appendix B contains examples that illustrate application of this Statement. Appendix C contains background information and the basis for the Board's conclusions. Appendix D lists the accounting pronouncements superseded or amended by this Statement. Appendix E provides a diagram for determining whether a contract is a freestanding derivative subject to the scope of this Statement.

Scope and Definition

5. This Statement applies to all entities. Some entities, such as not-for-profit organizations and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Statement to those entities is set forth in paragraph 43.

Derivative Instruments

6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:
a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

7. Underlying, notional amount, and payment provision. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

8. Initial net investment. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.

9. Net settlement. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.

b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12–16.

10. Notwithstanding the conditions in paragraphs 6–9, the following contracts are not subject to the requirements of this Statement:
a. “Regular-way” security trades. Regular-way security trades are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed.

b. Normal purchases and normal sales. Normal purchases and normal sales are contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

c. Certain insurance contracts. Generally, contracts of the type that are within the scope of FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:

(1) Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.

(2) Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

d. Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event. In contrast, financial guarantee contracts are subject to this Statement if they provide for payments to be made in response to changes in an underlying (for example, a decrease in a specified debtor’s creditworthiness).

e. Certain contracts that are not traded on an exchange. Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:

(1) A climatic or geological variable or other physical variable

(2) The price or value of (a) a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash
Specified volumes of sales or service revenues of one of the parties to
the contract.

If a contract has more than one underlying and some, but not all, of them qualify
for one of the exceptions in paragraphs 10(e)(1), 10(e)(2), and 10(e)(3), the
application of this Statement to that contract depends on its predominant
characteristics. That is, the contract is subject to the requirements of this
Statement if all of its underlyings, considered in combination, behave in a
manner that is highly correlated with the behavior of any of the component
variables that do not qualify for an exception.

Derivatives that serve as impediments to sales accounting. A derivative
instrument (whether freestanding or embedded in another contract) whose
existence serves as an impediment to recognizing a related contract as a sale by
one party or a purchase by the counterparty is not subject to this Statement. For
example, the existence of a guarantee of the residual value of a leased asset by
the lessor may be an impediment to treating a contract as a sales-type lease, in
which case the contract would be treated by the lessor as an operating lease.
Another example is the existence of a call option enabling a transferor to
repurchase transferred assets that is an impediment to sales accounting under
FASB Statement No. 125, Accounting for Transfers and Servicing of Financial
Assets and Extinguishments of Liabilities.

11. Notwithstanding the conditions of paragraphs 6–10, the reporting entity shall not consider
the following contracts to be derivative instruments for purposes of this Statement:

a. Contracts issued or held by that reporting entity that are both (1) indexed to its
own stock and (2) classified in stockholders’ equity in its statement of financial
position
b. Contracts issued by the entity in connection with stock-based compensation
arrangements addressed in FASB Statement No. 123, Accounting for Stock-
Based Compensation
c. Contracts issued by the entity as contingent consideration from a business
combination. The accounting for contingent consideration issued in a business
combination is addressed in APB Opinion No. 16, Business Combinations. In
applying this paragraph, the issuer is considered to be the entity that is
accounting for the combination using the purchase method.

In contrast, the above exceptions do not apply to the counterparty in those contracts. In
addition, a contract that an entity either can or must settle by issuing its own equity
instruments but that is indexed in part or in full to something other than its own stock can
be a derivative instrument for the issuer under paragraphs 6–10, in which case it would
be accounted for as a liability or an asset in accordance with the requirements of this
Statement.

Embedded Derivative Instruments

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer
to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain “embedded”
derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the
value of other exchanges required by the contract in a manner similar to a derivative instrument.
The effect of embedding a derivative instrument in another type of contract (“the host contract”) is
that some or all of the cash flows or other exchanges that otherwise would be required by the
contract, whether unconditional or contingent upon the occurrence of a specified event, will be
modified based on one or more underlyings. An embedded derivative instrument shall be
separated from the host contract and accounted for as a derivative instrument pursuant to this
Statement if and only if all of the following criteria are met:

a. The economic characteristics and risks of the embedded derivative instrument
are not clearly and closely related to the economic characteristics and risks of
the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.

b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

13. For purposes of applying the provisions of paragraph 12, an embedded derivative instrument in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is considered to be clearly and closely related to the host contract unless either of the following conditions exist:

a. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover substantially all of its initial recorded investment.

b. The embedded derivative could at least double the investor’s initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

Even though the above conditions focus on the investor’s rate of return and the investor’s recovery of its investment, the existence of either of those conditions would result in the embedded derivative instrument not being considered clearly and closely related to the host contract by both parties to the hybrid instrument. Because the existence of those conditions is assessed at the date that the hybrid instrument is acquired (or incurred) by the reporting entity, the acquirer of a hybrid instrument in the secondary market could potentially reach a different conclusion than could the issuer of the hybrid instrument due to applying the conditions in this paragraph at different points in time.

14. However, interest-only strips and principal-only strips are not subject to the requirements of this Statement provided they (a) initially resulted from separating the rights to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative that otherwise would have been accounted for separately as a derivative pursuant to the provisions of paragraphs 12 and 13 and (b) do not incorporate any terms not present in the original financial instrument described above.

15. An embedded foreign currency derivative instrument shall not be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the currency of the primary economic environment in which any substantial party to that contract operates (that is, its functional currency) or (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions). Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments, or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.
16. In subsequent provisions of this Statement, both (a) a derivative instrument included within the scope of this Statement by paragraphs 6–11 and (b) an embedded derivative instrument that has been separated from a host contract as required by paragraph 12 are collectively referred to as derivative instruments. If an embedded derivative instrument is separated from its host contract, the host contract shall be accounted for based on generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivative instruments. If an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.

Recognition of Derivatives and Measurement of Derivatives and Hedged Items
17. An entity shall recognize all of its derivative instruments in its statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. All derivative instruments shall be measured at fair value. The guidance in FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, as amended, shall apply in determining the fair value of a financial instrument (derivative or hedged item). If expected future cash flows are used to estimate fair value, those expected cash flows shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or the timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.

18. The accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. Either all or a proportion of a derivative may be designated as the hedging instrument. The proportion must be expressed as a percentage of the entire derivative so that the profile of risk exposures in the hedging portion of the derivative is the same as that in the entire derivative. (Thus, an entity is prohibited from separating a compound derivative into components representing different risks and designating any such component as the hedging instrument, except as permitted at the date of initial application by the transition provisions in paragraph 49.) Subsequent references in this Statement to a derivative as a hedging instrument include the use of only a proportion of a derivative as a hedging instrument. Two or more derivatives, or proportions thereof, may also be viewed in combination and jointly designated as the hedging instrument. Gains and losses on derivative instruments are accounted for as follows:

a. No hedging designation. The gain or loss on a derivative instrument not designated as a hedging instrument shall be recognized currently in earnings.

b. Fair value hedge. The gain or loss on a derivative instrument designated and qualifying as a fair value hedging instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk shall be recognized currently in earnings in the same accounting period, as provided in paragraphs 22 and 23.

c. Cash flow hedge. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraphs 30 and 31. The remaining gain or loss on the derivative instrument, if any, shall be recognized currently in earnings, as provided in paragraph 30.

d. Foreign currency hedge. The gain or loss on a derivative instrument or nonderivative financial instrument designated and qualifying as a foreign currency hedging instrument shall be accounted for as follows:

1. The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a foreign-currency-denominated firm commitment and the
offsetting loss or gain on the hedged firm commitment shall be recognized currently in earnings in the same accounting period, as provided in paragraph 37.

(2) The gain or loss on the hedging derivative instrument in a hedge of an available-for-sale security and the offsetting loss or gain on the hedged available-for-sale security shall be recognized currently in earnings in the same accounting period, as provided in paragraph 38.

(3) The effective portion of the gain or loss on the hedging derivative instrument in a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income (outside earnings) and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, as provided in paragraph 41. The remaining gain or loss on the hedging instrument shall be recognized currently in earnings.

(4) The gain or loss on the hedging derivative or nonderivative instrument in a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment to the extent it is effective as a hedge, as provided in paragraph 42.

19. In this Statement, the change in the fair value of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.

Fair Value Hedges

General

20. An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or a liability or an identified portion thereof ("hedged item") that is attributable to a particular risk. Designated hedging instruments and hedged items qualify for fair value hedge accounting if all of the following criteria and those in paragraph 21 are met:

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.

(1) For a fair value hedge of a firm commitment, the entity’s formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.

(2) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the
hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

c. If a written option is designated as hedging a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for gains as a result of a favorable change in the fair value of the combined instruments as exposure to losses from an unfavorable change in their combined fair value. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage.

(1) A combination of options (for example, an interest rate collar) entered into contemporaneously shall be considered a written option if either at inception or over the life of the contracts a net premium is received in cash or as a favorable rate or other term. (Thus, a collar can be designated as a hedging instrument in a fair value hedge without regard to the test in paragraph 20(c) unless a net premium is received.) Furthermore, a derivative instrument that results from combining a written option and any other nonoption derivative shall be considered a written option.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument, except as provided in paragraphs 37 and 42 of this Statement.

The Hedged Item

21. An asset or a liability is eligible for designation as a hedged item in a fair value hedge if all of the following criteria are met:

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment. The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).

(1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.

(2) If the hedged item is a specific portion of an asset or liability (or of a portfolio of similar assets or a portfolio of similar liabilities), the hedged item is one of the following:
(a) A percentage of the entire asset or liability (or of the entire portfolio)
(b) One or more selected contractual cash flows (such as the portion of the asset or liability representing the present value of the interest payments in the first two years of a four-year debt instrument)
(c) A put option, a call option, an interest rate cap, or an interest rate floor embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement
(d) The residual value in a lessor’s net investment in a direct financing or sales-type lease.

If the entire asset or liability is an instrument with variable cash flows, the hedged item cannot be deemed to be an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows.

b. The hedged item presents an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings. The reference to affecting reported earnings does not apply to an entity that does not report earnings as a separate caption in a statement of financial performance, such as a not-for-profit organization, as discussed in paragraph 43.

c. The hedged item is not (1) an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings), (2) an investment accounted for by the equity method in accordance with the requirements of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, (3) a minority interest in one or more consolidated subsidiaries, (4) an equity investment in a consolidated subsidiary, (5) a firm commitment either to enter into a business combination or to acquire or dispose of a subsidiary, a minority interest, or an equity method investee, or (6) an equity instrument issued by the entity and classified in stockholders’ equity in the statement of financial position.

d. If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to changes in the obligor’s creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component. (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to changes in market interest rates or foreign exchange rates. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

e. If the hedged item is a nonfinancial asset or liability (other than a recognized loan servicing right or a nonfinancial firm commitment with financial components), the designated risk being hedged is the risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). That is, the price risk of a similar asset in a different location or of a major ingredient may not be the hedged risk. Thus, in hedging the exposure to changes in the fair value of gasoline, an entity may not designate the risk of changes in the price of crude oil as the risk being hedged for purposes of determining effectiveness of the fair value hedge of gasoline.

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the
designated risk being hedged is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in its fair value attributable to changes in *market interest rates*, (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates *(refer to paragraphs 37 and 38)*, or (4) the risk of changes in its fair value attributable to changes in the obligor’s *creditworthiness*. If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (*market interest rate risk*, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity’s exposure to changes in the fair value of that “prepayment” option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of *market interest rate risk*.

22. Gains and losses on a qualifying fair value hedge shall be accounted for as follows:
   
   a. The gain or loss on the hedging instrument shall be recognized currently in earnings.
   
   b. The gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings.

If the fair value hedge is fully effective, the gain or loss on the hedging instrument, adjusted for the component, if any, of that gain or loss that is excluded from the assessment of effectiveness under the entity’s defined risk management strategy for that particular hedging relationship (as discussed in paragraph 63 in Section 2 of Appendix A), would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings. The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved. Although a hedging relationship must comply with an entity’s established policy range of what is considered “highly effective” pursuant to paragraph 20(b) in order for that relationship to qualify for hedge accounting, that compliance does not assure zero ineffectiveness. Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Any hedge ineffectiveness directly affects earnings because there will be no offsetting adjustment of a hedged item’s carrying amount for the ineffective aspect of the gain or loss on the related hedging instrument.

23. If a hedged item is otherwise measured at fair value with changes in fair value reported in other comprehensive income (such as an available-for-sale security), the adjustment of the hedged item’s carrying amount discussed in paragraph 22 shall be recognized in earnings rather than in other comprehensive income in order to offset the gain or loss on the hedging instrument.

24. The adjustment of the carrying amount of a hedged asset or liability required by paragraph 22 shall be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, an adjustment of the carrying amount of a hedged asset held for sale (such as inventory) would remain part of the carrying amount of that asset until the asset is sold, at which point the entire carrying amount of the hedged asset would be recognized as the cost of the item sold in determining earnings. An adjustment of the carrying amount of a hedged interest-bearing financial instrument shall be amortized to earnings;
amortization shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged.

25. An entity shall discontinue prospectively the accounting specified in paragraphs 22 and 23 for an existing hedge if any one of the following occurs:

   a. Any criterion in paragraphs 20 and 21 is no longer met.
   b. The derivative expires or is sold, terminated, or exercised.
   c. The entity removes the designation of the fair value hedge.

In those circumstances, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 25(a) and 25(c) above, a different hedged item or a hedged transaction if the hedging relationship meets the criteria specified in paragraphs 20 and 21 for a fair value hedge or paragraphs 28 and 29 for a cash flow hedge.

26. In general, if a periodic assessment indicates noncompliance with the effectiveness criterion in paragraph 20(b), an entity shall not recognize the adjustment of the carrying amount of the hedged item described in paragraphs 22 and 23 after the last date on which compliance with the effectiveness criterion was established. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criterion can be identified, the entity shall recognize in earnings the changes in the hedged item’s fair value attributable to the risk being hedged that occurred prior to that event or change in circumstances.

If a fair value hedge of a firm commitment is discontinued because the hedged item no longer meets the definition of a firm commitment, the entity shall derecognize any asset or liability previously recognized pursuant to paragraph 22 (as a result of an adjustment to the carrying amount for the firm commitment) and recognize a corresponding loss or gain currently in earnings.

Impairment

27. An asset or liability that has been designated as being hedged and accounted for pursuant to paragraphs 22–24 remains subject to the applicable requirements in generally accepted accounting principles for assessing impairment for that type of asset or for recognizing an increased obligation for that type of liability. Those impairment requirements shall be applied after hedge accounting has been applied for the period and the carrying amount of the hedged asset or liability has been adjusted pursuant to paragraph 22 of this Statement. Because the hedging instrument is recognized separately as an asset or liability, its fair value or expected cash flows shall not be considered in applying those impairment requirements to the hedged asset or liability.

Cash Flow Hedges

General

28. An entity may designate a derivative instrument as hedging the exposure to variability in expected future cash flows that is attributable to a particular risk. That exposure may be associated with an existing recognized asset or liability (such as all or certain future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). Designated hedging instruments and hedged items or transactions qualify for cash flow hedge accounting if all of the following criteria and those in paragraph 29 are met:

   a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument’s effectiveness in hedging the exposure to the hedged transaction’s variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument’s effectiveness.
(1) An entity’s defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative’s change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.

(2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.

(a) The phrase expected currency amount refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.

(b) The phrase expected quantity refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

The hedged forecasted transaction shall be described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction. Thus, the forecasted transaction could be identified as the sale of either the first 15,000 units of a specific product sold during a specified 3-month period or the first 5,000 units of a specific product sold in each of 3 specific months, but it could not be identified as the sale of the last 15,000 units of that product sold during a 3-month period (because the last 15,000 units cannot be identified when they occur, but only when the period has ended).

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c)(1).)

d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows. A link exists if the basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the
designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29(a) is applied separately to the designated asset and the designated liability.

A nonderivative instrument, such as a Treasury note, shall not be designated as a hedging instrument for a cash flow hedge.

The Hedged Forecasted Transaction

29. A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted by paragraph 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings). However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

e. If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to changes in market interest rates.

f. The forecasted transaction does not involve a business combination subject to the provisions of Opinion 16 and is not a transaction (such as a forecasted purchase, sale, or dividend) involving (1) a parent company’s interests in consolidated subsidiaries, (2) a minority interest in a consolidated subsidiary, (3) an equity-method investment, or (4) an entity’s own equity instruments.

g. If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged is (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. Thus, for example, in hedging the exposure to changes in the cash flows relating to the purchase of its bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged for purposes of assessing offset as required by paragraph 28(b).

h. If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or
liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in market interest rates, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (refer to paragraph 40), or (4) the risk of changes in its cash flows attributable to default or changes in the obligor’s creditworthiness. Two or more of the above risks may be designated simultaneously as being hedged. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

30. The effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income, and the ineffective portion is reported in earnings. More specifically, a qualifying cash flow hedge shall be accounted for as follows:
   a. If an entity’s defined risk management strategy for a particular hedging relationship excludes a specific component of the gain or loss, or related cash flows, on the hedging derivative from the assessment of hedge effectiveness (as discussed in paragraph 63 in Section 2 of Appendix A), that excluded component of the gain or loss shall be recognized currently in earnings. For example, if the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the changes in the option’s time value would be recognized in earnings. Time value is equal to the fair value of the option less its intrinsic value.
   b. Accumulated other comprehensive income associated with the hedged transaction shall be adjusted to a balance that reflects the lesser of the following (in absolute amounts):
      (1) The cumulative gain or loss on the derivative from inception of the hedge less (a) the excluded component discussed in paragraph 30(a) above and (b) the derivative’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31
      (2) The portion of the cumulative gain or loss on the derivative necessary to offset the cumulative change in expected future cash flows on the hedged transaction from inception of the hedge less the derivative’s gains or losses previously reclassified from accumulated other comprehensive income into earnings pursuant to paragraph 31.
   That adjustment of accumulated other comprehensive income shall incorporate recognition in other comprehensive income of part or all of the gain or loss on the hedging derivative, as necessary.
   c. A gain or loss shall be recognized in earnings, as necessary, for any remaining gain or loss on the hedging derivative or to adjust other comprehensive income to the balance specified in paragraph 30(b) above.

Section 2 of Appendix A illustrates assessing hedge effectiveness and measuring hedge ineffectiveness. Examples 6 and 9 of Section 1 of Appendix B illustrate the application of this paragraph.

31. Amounts in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings (for example, when a forecasted sale actually occurs). If the hedged transaction results in the acquisition of an asset or the incurrence of a liability, the gains and losses in accumulated other comprehensive income shall be reclassified into earnings in the same period or periods during which the asset acquired or liability incurred affects earnings (such as in the periods that depreciation expense, interest expense, or cost of sales is recognized). However, if an entity expects at any time that continued reporting of a loss in accumulated other comprehensive income would lead to recognizing a net loss on the combination of the hedging instrument and...
the hedged transaction (and related asset acquired or liability incurred) in one or more future periods, a loss shall be reclassified immediately into earnings for the amount that is not expected to be recovered. For example, a loss shall be reported in earnings for a derivative that is designated as hedging the forecasted purchase of inventory to the extent that the cost basis of the inventory plus the related amount reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory. (Impairment guidance is provided in paragraphs 34 and 35.)

32. An entity shall discontinue prospectively the accounting specified in paragraphs 30 and 31 for an existing hedge if any one of the following occurs:

   a. Any criterion in paragraphs 28 and 29 is no longer met.
   b. The derivative expires or is sold, terminated, or exercised.
   c. The entity removes the designation of the cash flow hedge.

In those circumstances, the net gain or loss shall remain in accumulated other comprehensive income and be reclassified into earnings as specified in paragraph 31. Furthermore, the entity may elect to designate prospectively a new hedging relationship with a different hedging instrument or, in the circumstances described in paragraphs 32(a) and 32(c), a different hedged transaction or a hedged item if the hedging relationship meets the criteria specified in paragraphs 28 and 29 for a cash flow hedge or paragraphs 20 and 21 for a fair value hedge.

33. If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income shall be immediately reclassified into earnings.

34. Existing requirements in generally accepted accounting principles for assessing asset impairment or recognizing an increased obligation apply to an asset or liability that gives rise to variable cash flows (such as a variable-rate financial instrument), for which the variable cash flows (the forecasted transactions) have been designated as being hedged and accounted for pursuant to paragraphs 30 and 31. Those impairment requirements shall be applied each period after hedge accounting has been applied for the period, pursuant to paragraphs 30 and 31 of this Statement. The fair value or expected cash flows of a hedging instrument shall not be considered in applying those requirements. The gain or loss on the hedging instrument in accumulated other comprehensive income shall, however, be accounted for as discussed in paragraph 31.

35. If, under existing requirements in generally accepted accounting principles, an impairment loss is recognized on an asset or an additional obligation is recognized on a liability to which a hedged forecasted transaction relates, any offsetting net gain related to that transaction in accumulated other comprehensive income shall be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss that has been accumulated in other comprehensive income shall be reclassified immediately into earnings.

Foreign Currency Hedges

36. Consistent with the functional currency concept in Statement 52, an entity may designate the following types of hedges of foreign currency exposure, as specified in paragraphs 37-42:

   a. A fair value hedge of an unrecognized firm commitment or an available-for-sale security
   b. A cash flow hedge of a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction
   c. A hedge of a net investment in a foreign operation.

The criterion in paragraph 21(c)(1) requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-
denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings. Similarly, the criterion in paragraph 29(d) requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings. A foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

Foreign Currency Fair Value Hedges
37.  Unrecognized firm commitment.  A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates.  The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met.

38.  Available-for-sale security.  A nonderivative financial instrument shall not be designated as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale security.  A derivative instrument can be designated as hedging the changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates.  The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 are met.  An available-for-sale equity security can be hedged for changes in the fair value attributable to changes in foreign currency exchange rates and qualify for the accounting specified in paragraphs 22–27 only if the fair value hedge criteria in paragraphs 20 and 21 are met and the following two conditions are satisfied:

   a.  The security is not traded on an exchange (or other established marketplace) on which trades are denominated in the investor's functional currency.

   b.  Dividends or other cash flows to holders of the security are all denominated in the same foreign currency as the currency expected to be received upon sale of the security.

The change in fair value of the hedged available-for-sale equity security attributable to foreign exchange risk is reported in earnings pursuant to paragraph 23 and not in other comprehensive income.

39.  Gains and losses on a qualifying foreign currency fair value hedge shall be accounted for as specified in paragraphs 22–27.  The gain or loss on a nonderivative hedging instrument attributable to foreign currency risk is the foreign currency transaction gain or loss as determined under Statement 52.  That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment.

Foreign Currency Cash Flow Hedges
40.  A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge.  A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with either a forecasted foreign-currency-denominated transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency) or a forecasted intercompany foreign-currency-denominated transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all of the following criteria are met:
a. The operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary—refer to paragraph 36).

b. The hedged transaction is denominated in a currency other than that unit’s functional currency.

c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.

d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

41. A qualifying foreign currency cash flow hedge shall be accounted for as specified in paragraphs 30–35.

Hedges of the Foreign Currency Exposure of a Net Investment in a Foreign Operation

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

Accounting by Not-for-Profit Organizations and Other Entities That Do Not Report Earnings

43. An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization or a defined benefit pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations, this Statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

Disclosures

44. An entity that holds or issues derivative instruments (or nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 37 and 42) shall disclose its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives. The description shall distinguish between derivative instruments (and nonderivative instruments) designated as fair value hedging instruments, derivative instruments designated as cash flow hedging instruments, derivative instruments (and nonderivative instruments) designated as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, and all other derivatives. The description also shall indicate the entity’s risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity. Qualitative disclosures about an entity’s objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity’s overall risk management profile. If
appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

45. An entity’s disclosures for every reporting period for which a complete set of financial statements is presented also shall include the following:

Fair value hedges
   a. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as fair value hedging instruments and for the related hedged items:
      (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
      (2) The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

Cash flow hedges
   b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
      (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges’ ineffectiveness and (b) the component of the derivative instruments’ gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain or loss is reported in the statement of income or other statement of financial performance
      (2) A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months
      (3) The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments
      (4) The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur.

Hedges of the net investment in a foreign operation
   c. For derivative instruments, as well as nonderivative instruments that may give rise to foreign currency transaction gains or losses under Statement 52, that have been designated and have qualified as hedging instruments for hedges of the foreign currency exposure of a net investment in a foreign operation, the net amount of gains or losses included in the cumulative translation adjustment during the reporting period.

The quantitative disclosures about derivative instruments may be more useful, and less likely to be perceived to be out of context or otherwise misunderstood, if similar information is disclosed about other financial instruments or nonfinancial assets and liabilities to which the derivative instruments are related by activity. Accordingly, in those situations, an entity is encouraged, but not required, to present a more complete picture of its activities by disclosing that information.
Reporting Changes in the Components of Comprehensive Income

46. An entity shall display as a separate classification within other comprehensive income the net gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments that are reported in comprehensive income pursuant to paragraphs 30 and 41.

47. As part of the disclosures of accumulated other comprehensive income, pursuant to paragraph 26 of FASB Statement No. 130, Reporting Comprehensive Income, an entity shall separately disclose the beginning and ending accumulated derivative gain or loss, the related net change associated with current period hedging transactions, and the net amount of any reclassification into earnings.

Effective Date and Transition

48. This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 1999. Initial application of this Statement shall be as of the beginning of an entity’s fiscal quarter; on that date, hedging relationships shall be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. Earlier application of selected provisions of this Statement is not permitted. This Statement shall not be applied retroactively to financial statements of prior periods.

49. At the date of initial application, an entity shall recognize all freestanding derivative instruments (that is, derivative instruments other than embedded derivative instruments) in the statement of financial position as either assets or liabilities and measure them at fair value, pursuant to paragraph 17. The difference between a derivative's previous carrying amount and its fair value shall be reported as a transition adjustment, as discussed in paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts at that date, as discussed in paragraph 52(b). Any gains or losses on derivative instruments that are reported independently as deferred gains or losses (that is, liabilities or assets) in the statement of financial position at the date of initial application shall be derecognized from that statement; that derecognition also shall be reported as transition adjustments as indicated in paragraph 52. Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application because the derivative instruments were hedging the fair value exposure of available-for-sale securities also shall be reported as transition adjustments; the offsetting losses and gains on the securities shall be accounted for pursuant to paragraph 52(b). Any gain or loss on a derivative instrument reported in accumulated other comprehensive income at the date of initial application because the derivative instrument was hedging the variable cash flow exposure of a forecasted (anticipated) transaction related to an available-for-sale security shall remain in accumulated other comprehensive income and shall not be reported as a transition adjustment. The accounting for any gains and losses on derivative instruments that arose prior to the initial application of the Statement and that were previously added to the carrying amount of recognized hedged assets or liabilities is not affected by this Statement. Those gains and losses shall not be included in the transition adjustment.

50. At the date of initial application, an entity also shall recognize as an asset or liability in the statement of financial position any embedded derivative instrument that is required pursuant to paragraphs 12–16 to be separated from its host contract if the hybrid instrument in which it is embedded was issued, acquired, or substantively modified by the entity after December 31, 1997. For all of its hybrid instruments that exist at the date of initial application and were issued or acquired before January 1, 1998 and not substantively modified thereafter, an entity may choose either (a) not to apply this Statement to any of those hybrid instruments or (b) to recognize as assets or liabilities all the derivative instruments embedded in those hybrid instruments that would be required pursuant to paragraphs 12–16 to be separated from their host contracts. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.
51. If an embedded derivative instrument is to be separated from its host contract in conjunction with the initial application of this Statement, the entity shall consider the following in determining the related transition adjustment:

a. The carrying amount of the host contract at the date of initial application shall be based on its fair value on the date that the hybrid instrument was issued or acquired by the entity and shall reflect appropriate adjustments for subsequent activity, such as subsequent cash receipts or payments and the amortization of any premium or discount on the host contract arising from the separation of the embedded derivative.

b. The carrying amount of the embedded derivative instrument at the date of initial application shall be its fair value.

c. The transition adjustment shall be the difference at the date of initial application between (1) the previous carrying amount of the hybrid instrument and (2) the sum of the new net carrying amount of the host contract and the fair value of the embedded derivative instrument. The entity shall not retroactively designate a hedging relationship that could have been made had the embedded derivative instrument initially been accounted for separate from the host contract.

52. The transition adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate, as the effect of a change in accounting principle and presented in a manner similar to the cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, Accounting Changes. Whether a transition adjustment related to a specific derivative instrument is reported in net income, reported in other comprehensive income, or allocated between both is based on the hedging relationships, if any, that had existed for that derivative instrument and that were the basis for accounting under generally accepted accounting principles before the date of initial application of this Statement.

a. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment shall be reported as a cumulative-effect-type adjustment of accumulated other comprehensive income.

b. If the transition adjustment relates to a derivative instrument that had been designated in a hedging relationship that addressed the fair value exposure of an asset, a liability, or a firm commitment, the transition adjustment for the derivative shall be reported as a cumulative-effect-type adjustment of net income. Concurrently, any gain or loss on the hedged item (that is, difference between the hedged item’s fair value and its carrying amount) shall be recognized as an adjustment of the hedged item’s carrying amount at the date of initial application, but only to the extent of an offsetting transition adjustment for the derivative. That adjustment of the hedged item’s carrying amount shall also be reported as a cumulative-effect-type adjustment of net income. The transition adjustment related to the gain or loss reported in accumulated other comprehensive income on a derivative instrument that hedged an available-for-sale security, together with the loss or gain on the related security (to the extent of an offsetting transition adjustment for the derivative instrument), shall be reclassified to earnings as a cumulative-effect-type adjustment of both net income and accumulated other comprehensive income.

c. If a derivative instrument had been designated in multiple hedging relationships that addressed both the fair value exposure of an asset or a liability and the variable cash flow exposure of a forecasted (anticipated) transaction, the transition adjustment for the derivative shall be allocated between the cumulative-effect-type adjustment of net income and the cumulative-effect-type adjustment of accumulated other comprehensive income and shall be reported...
as discussed in paragraphs 52(a) and 52(b) above. Concurrently, any gain or loss on the hedged item shall be accounted for at the date of initial application as discussed in paragraph 52(b) above.

d. Other transition adjustments not encompassed by paragraphs 52(a), 52(b), and 52(c) above shall be reported as part of the cumulative-effect-type adjustment of net income.

53. Any transition adjustment reported as a cumulative-effect-type adjustment of accumulated other comprehensive income shall be subsequently reclassified into earnings in a manner consistent with paragraph 31. For those amounts, an entity shall disclose separately in the year of initial application the amount of gains and losses reported in accumulated other comprehensive income and associated with the transition adjustment that are being reclassified into earnings during the 12 months following the date of initial application.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in market interest rates, changes in foreign currency exchange rates, or changes in its overall fair value. (Paragraph 21(d) precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of market interest rate risk or the risk of changes in its overall fair value. Paragraph 29(e) similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of market interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other comprehensive income consistent with the requirements of paragraphs 15(b) and 15(c) of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from the held-to-maturity category at the date of initial adoption shall not call into question an entity’s intent to hold other debt securities to maturity in the future.

55. At the date of initial application, an entity may transfer any available-for-sale security into the trading category. After any related transition adjustments from initially applying this Statement have been recognized, the unrealized holding gain or loss remaining in accumulated other comprehensive income for any transferred security at the date of initial application shall be reclassified into earnings (but not reported as part of the cumulative-effect-type adjustment for the transition adjustments), consistent with paragraph 15(b) of Statement 115. If a derivative instrument had been hedging the variable cash flow exposure of a forecasted transaction related to an available-for-sale security that is transferred into the trading category at the date of initial application and the entity had reported a gain or loss on that derivative instrument in other comprehensive income (consistent with paragraph 115 of Statement 115), the entity also shall reclassify those derivative gains and losses into earnings (but not report them as part of the cumulative-effect-type adjustment for the transition adjustments).

56. At the date of initial application, mortgage bankers and other servicers of financial assets may choose to restratify their servicing rights pursuant to paragraph 37(g) of Statement 125 in a manner that would enable individual strata to comply with the requirements of this Statement regarding what constitutes “a portfolio of similar assets.” As noted in footnote 9 of this Statement, mortgage bankers and other servicers of financial assets that designate a hedged portfolio by aggregating servicing rights within one or more risk strata used under paragraph 37(g) of Statement 125 would not necessarily comply with the requirement in paragraph 21(a) of this Statement for portfolios of similar assets, since the risk stratum under paragraph 37(g) of Statement 125 can be based on any predominant risk characteristic, including date of origination or geographic location. The restratification of servicing rights is a change in the application of an accounting principle, and the effect of that change as of the initial application of this Statement shall be reported as part of the cumulative-effect-type adjustment for the transition adjustments.
65. FAS 137 provides the following:

Amendments to Statement 133
3. Statement 133 is amended as follows:

a. The first sentence of paragraph 48 is replaced by the following:

This Statement shall be effective for all fiscal quarters of all fiscal years beginning after June 15, 2000.

b. Paragraph 50 is replaced by the following:

At the date of initial application, an entity shall choose to either (a) recognize as an asset or liability in the statement of financial position all embedded derivative instruments that are required pursuant to paragraphs 12–16 to be separated from their host contracts or (b) select either January 1, 1998 or January 1, 1999 as a transition date for embedded derivatives. If the entity chooses to select a transition date, it shall recognize as separate assets and liabilities (pursuant to paragraphs 12–16) only those derivatives embedded in hybrid instruments issued, acquired, or substantively modified by the entity on or after the selected transition date. That choice is not permitted to be applied to only some of an entity’s individual hybrid instruments and must be applied on an all-or-none basis.

Effective Date
4. This Statement is effective upon issuance. An entity that has already applied the provisions of Statement 133 and has issued interim or annual financial statements reflecting that application may not revert to a previous method of accounting for derivative instruments and hedging activities.

66. FAS 138 provides the following (certain sections not affecting the excerpted FAS No. 133 guidance excluded):

Amendments to Statement 133
4. Statement 133 is amended as follows:

Amendment Related to Normal Purchases and Normal Sales
a. Paragraph 10(b) is replaced by the following:

Normal purchases and normal sales. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets neither of the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) may qualify for the normal purchases and normal sales exception if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise
settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

Amendments to Redefine Interest Rate Risk
b. Paragraph 21 is amended as follows:

(1) The first sentence of subparagraph (d) is replaced by the following:

If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, the designated risk being hedged is the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both. If the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.

(2) In the first parenthetical sentence of subparagraph (d), changes in market interest rates or foreign exchange rates is replaced by interest rate risk.

(3) In subparagraph (f)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(4) In subparagraph (f)(3), (refer to paragraphs 37 and 38) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 37, 37A, and 38).

(5) In subparagraph (f)(4), both is inserted between to and changes and the obligor’s creditworthiness is replaced by the obligor’s creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

(6) In the second sentence of subparagraph (f), market is deleted.

(7) In subparagraph (f), the following sentences and footnote are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item’s fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item’s contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.

(8) In the fourth sentence of subparagraph (f), overall is inserted between exposure to changes in the and fair value of that.

(9) In the last sentence of subparagraph (f), market is deleted.
c. Paragraph 29 is amended as follows:

(1) In the first sentence of subparagraph (e), default or changes in the obligor’s creditworthiness is replaced by credit risk, foreign exchange risk, or both.

(2) In the last sentence of subparagraph (e), changes in market interest rates is replaced by interest rate risk.

(3) In the first sentence of subparagraph (h), (or the interest payments on that financial asset or liability) is added after sale of a financial asset or liability.

(4) In subparagraph (h)(1), the risk of changes in the cash flows of the entire asset or liability is replaced by the risk of overall changes in the hedged cash flows related to the asset or liability.

(5) In subparagraph (h)(2), market interest rates is replaced by the designated benchmark interest rate (referred to as interest rate risk).

(6) In subparagraph (h)(3), (refer to paragraph 40) is replaced by (referred to as foreign exchange risk) (refer to paragraphs 40, 40A, 40B, and 40C).

(7) In subparagraph (h)(4), default or changes in the obligor’s creditworthiness is replaced by default, changes in the obligor’s creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge (referred to as credit risk).

(8) In subparagraph (h), the following sentences are added after the second sentence:

The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In a cash flow hedge of a variable-rate financial asset or liability, either existing or forecasted, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the specifically identified benchmark interest rate if the cash flows of the hedged transaction are explicitly based on a different index, for example, based on a specific bank’s prime rate, which cannot qualify as the benchmark rate. However, the risk designated as being hedged could potentially be the risk of overall changes in the hedged cash flows related to the asset or liability, provided that the other criteria for a cash flow hedge have been met.

d. Paragraph 54 is amended as follows:

(1) In the second sentence, market interest rates, changes in foreign currency exchange rates, is replaced by the designated benchmark interest rate.

(2) In the third and fourth (parenthetical) sentences, market is deleted.

(3) In the penultimate sentence of footnote 14, market interest rates is replaced by interest rate risk.

e. In the first sentence of paragraph 90, market is deleted.

Amendments Related to Hedging Recognized Foreign-Currency-Denominated Assets and Liabilities

f. In paragraph 21(c)(1), (for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings) is deleted.

g. Paragraph 29(d) is amended as follows:

1) In the first sentence, (for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings) is deleted.
(2) The second sentence is deleted.

h. In paragraph 29(g)(2), (reflecting its actual location if a physical asset) is replaced by reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity’s functional currency or a foreign currency).

i. The following subparagraph is added after subparagraph (c) of paragraph 30:

d. In a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from the remeasurement and adjust earnings for the cost to the purchaser (income to the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings.

j. Paragraph 36 is amended as follows:

(1) In the first sentence, Consistent with the functional currency concept in Statement 52 is replaced by If the hedged item is denominated in a foreign currency.

(2) In subparagraph (a), an available-for-sale security is replaced by a recognized asset or liability (including an available-for-sale security).

(3) Subparagraph (b) is replaced by the following:

A cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction.

(4) The first two sentences following subparagraph (c) are replaced by the following:

The recognition in earnings of the foreign currency transaction gain or loss on a foreign-currency-denominated asset or liability based on changes in the foreign currency spot rate is not considered to be the remeasurement of that asset or liability with changes in fair value attributable to foreign exchange risk recognized in earnings, which is discussed in the criteria in paragraphs 21(c)(1) and 29(d). Thus, those criteria are not impediments to either a foreign currency fair value or cash flow hedge of such a foreign-currency-denominated asset or liability or a foreign currency cash flow hedge of the forecasted acquisition or incurrence of a foreign-currency-denominated asset or liability whose carrying amount will be remeasured at spot exchange rates under paragraph 15 of Statement 52.

k. The following paragraph is added after paragraph 36:

36A. The provisions in paragraph 36 that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. An entity may choose to designate a single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit. Alternatively, an entity may choose to designate a cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit and then separately designate a foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable. In that case, the cash flow hedge would terminate (be dedesignated) when the hedged sale or purchase occurs and the foreign-currency-denominated receivable or payable is recognized. The
use of the same foreign currency derivative instrument for both the cash flow
hedge and the fair value hedge is not prohibited though some ineffectiveness
may result.

I. The following paragraph is added after paragraph 37:

37A. Recognized asset or liability. A nonderivative financial instrument shall
not be designated as the hedging instrument in a fair value hedge of the foreign
currency exposure of a recognized asset or liability. A derivative instrument can
be designated as hedging the changes in the fair value of a recognized asset or
liability (or a specific portion thereof) for which a foreign currency transaction gain
or loss is recognized in earnings under the provisions of paragraph 15 of
Statement 52. All recognized foreign-currency-denominated assets or liabilities
for which a foreign currency transaction gain or loss is recorded in earnings may
qualify for the accounting specified in paragraphs 22-27 if all the fair value hedge
criteria in paragraphs 20 and 21 and the conditions in paragraphs 40(a) and
40(b) are met.

m. Paragraph 40 is amended as follows:

(1) The second sentence is replaced by the following:
A derivative instrument designated as hedging the foreign currency exposure to
variability in the functional-currency-equivalent cash flows associated
with a forecasted transaction (for example, a forecasted export sale to an
unaffiliated entity with the price to be denominated in a foreign currency),
a recognized asset or liability, an unrecognized firm commitment, or a
forecasted intercompany transaction (for example, a forecasted sale to a
foreign subsidiary or a forecasted royalty from a foreign subsidiary)
qualifies for hedge accounting if all the following criteria are met:

The following subparagraph is added:

(2) e. If the hedged item is a recognized foreign-currency-denominated
asset or liability, all the variability in the hedged item’s functional-
currency-equivalent cash flows must be eliminated by the effect of the
hedge. (For example, a cash flow hedge cannot be used with a variable-
rate foreign-currency-denominated asset or liability and a derivative
based solely on changes in exchange rates because the derivative does
not eliminate all the variability in the functional currency cash flows.)

Amendments Related to Intercompany Derivatives

n. In the last sentence of paragraph 36, in a fair value hedge or in a cash flow
hedge of a recognized foreign-currency-denominated asset or liability or in a net
investment hedge is added after can be a hedging instrument.

o. The following paragraphs are added after paragraph 40:

40A. Internal derivative. A foreign currency derivative contract that has been
entered into with another member of a consolidated group (such as a treasury
center) can be a hedging instrument in a foreign currency cash flow hedge of a
forecasted borrowing, purchase, or sale or an unrecognized firm commitment in
the consolidated financial statements only if the following two conditions are
satisfied. (That foreign currency derivative instrument is hereafter in this section
referred to as an internal derivative.)

a. From the perspective of the member of the consolidated group
using the derivative as a hedging instrument (hereafter in this section
referred to as the hedging affiliate), the criteria for foreign currency cash
flow hedge accounting in paragraph 40 must be satisfied.

b. The member of the consolidated group not using the derivative
as a hedging instrument (hereafter in this section referred to as the
issuing affiliate) must either (1) enter into a derivative contract with an
unrelated third party to offset the exposure that results from that internal
derivative or (2) if the conditions in paragraph 40B are met, enter into
derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts.

40B. Offsetting net exposures. If an issuing affiliate chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as cash flow hedges in the consolidated financial statements only if all of the following conditions are satisfied:

a. The issuing affiliate enters into a derivative contract with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts, and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.

b. Internal derivatives that are not designated as hedging instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative. In addition, nonderivative contracts may not be used as hedging instruments to offset exposures arising from internal derivative contracts.

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that mature within the same 31-day period and that involve the same currency exposure as the net third-party derivative. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each internal derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.

e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate any offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.

40C. A member of a consolidated group is not permitted to offset exposures arising from multiple internal derivative contracts on a net basis for foreign currency cash flow exposures related to recognized foreign-currency-denominated assets or liabilities. That prohibition includes situations in which a recognized foreign-currency-denominated asset or liability in a fair value hedge or cash flow hedge results from the occurrence of a specifically identified forecasted transaction initially designated as a cash flow hedge.

Amendments for Certain Interpretations of Statement 133 Cleared by the Board Relating to the Derivatives Implementation Group Process

p. In the second sentence of paragraph 12, host is inserted between would be required by the and contract, whether unconditional.

Amendments to Implement Guidance in Implementation Issue No. G3, "Discontinuation of a Cash Flow Hedge"

q. Paragraph 33 is replaced by the following:
The net derivative gain or loss related to a discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (as documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter, except
as indicated in the following sentence. In rare cases, the existence of extenuating circumstances that are related to the nature of the forecasted transaction and are outside the control or influence of the reporting entity may cause the forecasted transaction to be probable of occurring on a date that is beyond the additional two-month period of time, in which case, the net derivative gain or loss related to the discontinued cash flow hedge shall continue to be reported in accumulated other comprehensive income until it is reclassified into earnings pursuant to paragraph 31. If it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified time period or within the additional two-month period of time and the hedged forecasted transaction also does not qualify for the exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income shall be reclassified into earnings immediately.

r. The following is added at the end of paragraph 45(b)(4):
by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

Amendments to Implement Guidance in Implementation Issue No. H1, “Hedging at the Operating Unit Level”

s. In the last sentence of paragraph 37, and the conditions in paragraphs 40(a) and 40(b) is added between paragraphs 20 and 21 and are met.

t. In the third sentence of paragraph 38, and the conditions in paragraphs 40(a) and 40(b) is added between paragraphs 20 and 21 and are met.

u. In paragraph 42, provided the conditions in paragraphs 40(a) and 40(b) are met is added to the end of the first sentence.

Amendments to Implement Guidance in Implementation Issue No. H2, “Requirement That the Unit with the Exposure Must Be a Party to the Hedge”

v. Paragraph 40 is amended as follows:
(1) Subparagraph (a) is replaced by the following:
For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency. (Refer to paragraphs 36, 40A, and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)

(2) In subparagraph (b), that is replaced by the hedging.

OTHER SOURCES OF INFORMATION:
67. The Financial Accounting Standards Board established the Derivatives Implementation Group to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff’s views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation. E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges and E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach are included as part of Exhibit A:
RELEVANT LITERATURE:

Statutory Accounting
- Statement of Statutory Accounting Principle No. 31 – Derivative Instruments
- Minutes of the June 7, 1999 Emerging Accounting Issues working group meeting

Generally Accepted Accounting Principles
- FASB Statement No. 80, Accounting for Futures Contracts
- FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities
- FASB Statement No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133 - an amendment of FASB Statement No. 133
- FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities - an amendment of FASB Statement No. 133
- EITF 98-10, Accounting for Contracts Involved in Energy Trading and Risk Management Activities
- EITF 98-12, Application of Issue No. 96-13 to Forward Equity Sales Transactions
- EITF 99-01, Accounting for Debt Convertible into the Stock of a Consolidated Sub
- EITF 99-02, Accounting for Weather Derivatives
- EITF 99-03, Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives
- EITF 99-08, Accounting for Transfers of Assets That Are Derivative Instruments but That Are Not Financial Assets
- EITF 99-09, Effect of Derivative Gains and Losses on the Capitalization of Interest
- EITF 00-07, Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur
- EITF 00-09, Classification of a Gain or Loss from a Hedge of Debt That Is Extinguished
EXHIBIT A - DISCUSSION OF HEDGING EFFECTIVENESS

The Financial Accounting Standards Board established the Derivatives Implementation Group in 1999 to address execution of FAS No. 133. The Derivatives Implementation Group addressed two issues related to effectiveness that are applicable to this issue paper. The issues have been authored by the FASB staff and represents the staff’s views, although FASB has discussed the responses at a public meeting and chosen not to object to dissemination of those responses. Official positions of the FASB are determined only after extensive due process and deliberation.

No. E7: Hedging—General: Methodologies to Assess Effectiveness of Fair Value and Cash Flow Hedges

Paragraph references: 20(b), 22, 28(b), 62, 86, 87
Date cleared by Board: May 17, 2000

QUESTION
1. Since Statement 133 provides an entity with flexibility in choosing the method it will use in assessing hedge effectiveness, must an entity use a dollar-offset approach in assessing effectiveness?

BACKGROUND
2. Paragraph 20(b) of Statement 133 states, in part:

Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months.

3. Paragraph 28(b) indicates a similar requirement that the hedging relationship be expected to be highly effective in achieving offsetting changes in cash flows attributable to the hedged risk during the period that the hedge is designated.

4. Paragraph 22 of Statement 133 states, in part:

The measurement of hedge ineffectiveness for a particular hedging relationship shall be consistent with the entity’s risk management strategy and the method of assessing hedge effectiveness that was documented at the inception of the hedging relationship, as discussed in paragraph 20(a). Nevertheless, the amount of hedge ineffectiveness recognized in earnings is based on the extent to which exact offset is not achieved.

5. Paragraph 62 emphasizes that each entity must “define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged.” It also states, “This Statement does not specify a single method for either assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness.”

RESPONSE
6. No. Statement 133 requires an entity to consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations.

a. Prospective considerations.
Upon designation of a hedging relationship (as well as on an ongoing basis), the entity must be able to justify an expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows. That expectation, which is forward-looking, can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information.

b. Retrospective evaluations.

At least quarterly, the hedging entity must determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment. That assessment can be based upon regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. If an entity elects at the inception of a hedging relationship to utilize the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship those regression analysis calculations should generally incorporate the same number of data points. Electing to utilize a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period as discussed below.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge’s effectiveness. That paragraph also states that ordinarily “an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.” Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at the inception of a hedging relationship to utilize a regression analysis approach for prospective considerations of assessing effectiveness and the dollar-offset method to perform retrospective evaluations of assessing effectiveness, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Thus, in its retrospective evaluation, an entity might conclude that, under a dollar-offset approach, a designated hedging relationship does not qualify for hedge accounting for the period just ended, but that the hedging relationship may continue because, under a regression analysis approach, there is an expectation that the relationship will be highly effective in achieving offsetting changes in fair value or cash flows in future periods. In its retrospective evaluation, if that entity concludes that, under a dollar-offset approach, the hedging relationship has not been highly effective in having achieved offsetting changes in fair value or cash flows, hedge accounting may not be applied in the current period. Whenever a hedging relationship fails to qualify for hedge accounting in a certain assessment period, the overall change in fair value of the derivative for that current period is recognized in earnings (not reported in other comprehensive income for a cash flow hedge) and the change in fair value of the hedged item would not be recognized in earnings for that period (for a fair value hedge).

8. If an entity elects at the inception of a hedging relationship to utilize a regression analysis (or other statistical analysis) approach for either prospective considerations or retrospective evaluations of assessing effectiveness, then that entity must periodically update its regression analysis (or other statistical analysis). For example, if there is significant ineffectiveness measured and recognized in earnings for a hedging relationship, which is calculated each assessment period, the regression analysis should be rerun to determine whether the expectation of high effectiveness is still valid. As long as an entity reruns its regression analysis and determines that the hedging relationship is still expected to be highly effective, then it can continue to apply hedge accounting without interruption.

9. In all instances, the actual measurement of hedge ineffectiveness to be recognized in earnings each reporting period is based on the extent to which exact offset is not achieved as specified in paragraph
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22 of Statement 133 (for fair value hedges) or paragraph 30 (for cash flow hedges). That requirement applies even if a regression or other statistical analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness supports an expectation that the hedging relationship will be highly effective and demonstrates that it has been highly effective, respectively.

10. The application of a regression or other statistical analysis approach to assessing effectiveness is complex. Those methodologies require appropriate interpretation and understanding of the statistical inferences.

E8: Hedging—General: Assessing Hedge Effectiveness of Fair Value and Cash Flow Hedges Period-by-Period or Cumulatively under a Dollar-Offset Approach

Paragraph references: 20(b), 28(b), 30, 62, 64, 67
Date cleared by Board: June 28, 2000

QUESTION

1. In periodically assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows), an entity compares the change in the hedging instrument’s fair value (or cash flows) to the change in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the hedged risk. If an entity elects at inception of a hedging relationship to utilize the dollar-offset approach for retrospective evaluations of assessing effectiveness, then should that entity base that comparison on (a) the fair value (or cash flow) changes that have occurred during the period being assessed (that is, on a period-by-period basis) or (b) the cumulative fair value (or cash flow) changes to date from the inception of the hedge? Is that entity permitted to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges) under a dollar-offset approach?

BACKGROUND

2. Paragraph 20(b) of Statement 133 states, in part:

   Both at inception of the [fair value] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months….All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship.

3. Paragraph 28(b) states, in part:

   Both at inception of the [cash flow] hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months….All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

4. Paragraph 30(b) states that “the effective portion of the gain or loss on a derivative designated as a cash flow hedge is reported in other comprehensive income.” Paragraph 30(b) specifies how the effective portion to be reported in other comprehensive income should be calculated. The calculation of the effective portion is, in part, based on “cumulative gain or loss on the derivative from inception of the hedge.”
5. Paragraph 67 of the Statement states, in part:

If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test and also would measure any ineffectiveness during the hedge period. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting.

RESPONSE

6. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a dollar-offset approach, Statement 133 permits an entity to use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges). The period-by-period approach involves comparing the changes in the hedging instrument’s fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged that have occurred during the same period. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument’s fair values (or cash flows) to the cumulative changes in the hedged item’s fair value (or hedged transaction’s cash flows) attributable to the risk hedged. At inception of the hedge, an entity may choose either approach in designating how effectiveness will be assessed, depending on the nature of the hedge documented in accordance with paragraphs 20(a) and 28(a). For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances.

7. Paragraph 62 requires that at the time an entity designates a hedging relationship, it must define and document the method it will use to assess the hedge’s effectiveness. That paragraph also states that ordinarily “an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.” Furthermore, it requires that an entity use that defined and documented methodology consistently throughout the period of the hedge. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period.

8. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods prior to the period being assessed are not relevant.

9. The foregoing guidance relates to an entity’s periodic retrospective assessment and determining whether a hedging relationship continues to qualify for hedge accounting; it does not relate to the actual measurement of hedge ineffectiveness to be recognized in earnings under hedge accounting. The actual measurement of ineffectiveness is based on the extent to which exact offset is not achieved as specified in paragraph 22 for fair value hedges or paragraph 30 for cash flow hedges.

10. The above response has been authored by the FASB staff and represents the staff’s views, although the Board has discussed the above response at a public meeting and chosen not to object to dissemination of that response. Official positions of the FASB are determined only after extensive due process and deliberation.
EXHIBIT B – ASSESSMENT OF HEDGING EFFECTIVENESS

The following is based on paragraphs 62-70 of FAS 133 to offer additional guidance on assessing hedging effectiveness. The intent of such is to remain consistent with FAS 133 with respect to assessing hedge effectiveness.

1. This issue paper requires that an entity define at the time it designates a hedging relationship the method it will use to assess the hedge’s effectiveness in achieving offsetting changes in fair value or offsetting cash flows attributable to the risk being hedged. It also requires that an entity use that defined method consistently throughout the hedge period to assess at inception of the hedge and on an ongoing basis whether it expects the hedging relationship to be highly effective in achieving offset. If the entity identifies an improved method and wants to apply that method prospectively, it must discontinue the existing hedging relationship and designate the relationship anew using the improved method. Although this issue paper suggests a method for assessing whether a hedge is expected to be highly effective or measuring hedge ineffectiveness, the appropriateness of a given method of assessing hedge effectiveness can depend on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, however, an entity should assess effectiveness for similar hedges in a similar manner; use of different methods for similar hedges should be justified.

2. In defining how hedge effectiveness will be assessed, an entity must specify whether it will include in that assessment all of the gain or loss on a hedging instrument. This issue paper permits (but does not require) an entity to exclude all or a part of the hedging instrument’s time value from the assessment of hedge effectiveness, as follows:

   a. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s intrinsic value, the change in the time value of the contract would be excluded from the assessment of hedge effectiveness.

   b. If the effectiveness of a hedge with an option contract is assessed based on changes in the option’s minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract would be excluded from the assessment of hedge effectiveness.

   c. If the effectiveness of a hedge with a forward or futures contract is assessed based on changes in fair value attributable to changes in spot prices, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price would be excluded from the assessment of hedge effectiveness.

In each circumstance above, changes in the excluded component would be included in unrealized gains or losses. As noted in paragraph 1, the effectiveness of similar hedges generally should be assessed similarly; that includes whether a component of the gain or loss on a derivative is excluded in assessing effectiveness. No other components of a gain or loss on the designated hedging instrument may be excluded from the assessment of hedge effectiveness.

3. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.
4. Whether a hedging relationship qualifies as highly effective sometimes will be easy to assess. If the critical terms of the hedging instrument and of the entire hedged asset or liability (as opposed to selected cash flows) or hedged forecasted transaction are the same, the entity could conclude that changes in fair value or cash flows attributable to the risk being hedged are expected to completely offset at inception and on an ongoing basis. For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be highly effective if:

   a. The forward contract is for purchase of the same quantity of the same commodity at the same time and location as the hedged forecasted purchase.
   b. The fair value of the forward contract at inception is zero.
   c. Either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and included directly in unrealized gains and losses pursuant to paragraph 22B or the change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

5. However, assessing hedge effectiveness can be more complex. For example, hedge effectiveness would be reduced by the following circumstances, among others: a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction (such as a Deutsche mark-based hedging instrument and Dutch guilder-based hedged item), to the extent that those bases do not move in tandem. b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in notional amounts, maturities, quantity, location, or delivery dates. Hedge effectiveness also would be reduced if part of the change in the fair value of a derivative is attributable to a change in the counterparty’s creditworthiness.

6. A hedge that meets the effectiveness test specified in paragraphs 20 b. and 21 b. (that is, both at inception and on an ongoing basis, the entity expects the hedge to be highly effective at achieving offsetting changes in fair values or cash flows) also must meet the other hedge accounting criteria to qualify for hedge accounting. If the hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test. If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. The discussions of measuring hedge effectiveness in the examples in the remainder of this Exhibit assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Assuming Effectiveness in a Hedge with an Interest Rate Swap

7. An entity may assume effectiveness in a hedging relationship of interest rate risk involving an interest-bearing asset or liability and an interest rate swap if all of the applicable conditions in the following list are met:

   Conditions applicable to both fair value hedges and cash flow hedges

   a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability.
   b. The fair value of the swap at its inception is zero.
   c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
   d. The interest-bearing asset or liability is not prepayable.
   e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.
Conditions applicable to fair value hedges only

f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
g. There is no floor or ceiling on the variable interest rate of the swap.
h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
k. The repricing dates match those of the variable-rate asset or liability.
l. The index on which the variable rate is based matches the index on which the asset or liability’s variable rate is based.

8. The fixed rate on a hedged item need not exactly match the fixed rate on a swap designated as a fair value hedge. Nor does the variable rate on an interest-bearing asset or liability need to be the same as the variable rate on a swap designated as a cash flow hedge. A swap’s fair value comes from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount. That is, a swap with a payment based on LIBOR and a receipt based on a fixed rate of 5 percent has the same net settlements and fair value as a swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent.

9. Comparable credit risk at inception is not a condition for assuming effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition to assume no ineffectiveness in a hedge of interest rate risk.
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Statutory Issue Paper No. 116

Claim Adjustment Expenses, Amendments to SSAP No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses

STATUS
Finalized October 16, 2001

Type of Issue:
Life and Health, Health Entities

SUMMARY OF ISSUE

1. Statement of Statutory Accounting Principles No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses (SSAP No. 55) prescribes the accounting treatment for recording unpaid claims and claim adjustment expenses for life insurance contracts and accident and health contracts and unpaid losses and loss adjustment expenses for property and casualty insurance contracts.

2. The purpose of this issue paper is to amend SSAP No. 55 to provide clarification regarding what costs should be classified as claim adjustment expenses on accident and health contracts. The conclusions outlined in the issue paper are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

RECOMMENDED CONCLUSION

3. Certain claim adjustment expenses reduce the number or cost of health services thereby resulting in lower premiums or lower premium increases. These claim adjustment expenses shall be classified as cost containment expenses.

4. This issue paper amends paragraph 6 c. of SSAP No. 55 to the following:

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

   i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

      (a) Case management activities;

      (b) Utilization review;

      (c) Detection and prevention of payment for fraudulent requests for reimbursement;

      (d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;
(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6 c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties; and

(e) Supplies and postage.

5. This issue paper amends paragraph 7 b. of SSAP No. 55 to the following:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.
Claim Adjustment Expenses, Amendments to SSAP No. 55, Unpaid Claims, Losses and Loss Adjustment Expenses

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7 b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;
(b) Maintaining records, general clerical, and secretarial;
(c) Office maintenance, occupancy costs, utilities, and computer maintenance;
(d) Supervisory and executive duties; and
(e) Supplies and postage.

Effective Date
6. This issue paper is effective for years ending on and after December 31, 2003.

DISCUSSION

7. In the past, no definitive statutory guidance existed addressing claim adjustment expenses and which expenses should be classified as claim adjustment expenses. In January 2000, the Statutory Accounting Principles Working Group requested assistance from the Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) in providing clarification as to what expenses should be classified as claim adjustment expenses and whether certain claim adjustment expenses should receive special treatment for reporting purposes. The A&HWG made its final recommendations at its March 23, 2001 meeting. The A&HWG determined that claim adjustment expenses shall be subdivided into cost containment expenses and other claim adjustment expenses. The A&HWG also developed a list of items that qualify as cost containment expenses. This issue paper adopts the recommendations of the A&HWG.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
8. SSAP No. 55, paragraph 6.c.:

6.c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

9. SSAP No. 55, paragraph 7.b.:

7.b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Examples of expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies, and postage;

10. The Accident and Health Working Group of the Life and Health Actuarial Task Force (A&HWG) reviewed in detail the topics of claim adjustment expenses and medical cost containment expenses and whether certain claim adjustment expenses should be included in losses or loss adjustment expenses. The
A&HWG made its final recommendations at its March 23, 2001 meeting. The conclusion of this issue paper is consistent with the A&HWG’s recommendation. The applicable section of the minutes is included herein:

At the 2000 Spring National Meeting, a request for assistance concerning codification issues was received from the Statutory Accounting Principles (E) Working Group (pages 90-91 of the Life and Health Actuarial Subscription, February 2000). The Accident and Health Working Group sent preliminary recommendations to the Statutory Accounting (E) Principles Working Group at the Fall National Meeting (Attachment Seven-B of the Accident and Health Working Group’s Sept. 8, 2000, minutes). The recommendations addressed whether cost containment expenses should be included in losses or loss adjustment expenses. The Codification Subteam of the Accident and Health Working Group continued work on addressing how the prior recommendations could be implemented into the Health Annual Statement and in the Life, Accident and Health Annual Statement. This was the focus of the Feb.15 and March 2 conference calls.

At the 2001 Spring National Meeting, John Rink (NE), chair of the Codification Subteam, reviewed the proposed memorandum to the Statutory Accounting Principles (E) Working Group. Mr. Rink noted that the recommendations in the proposed memorandum were designed to generate minimal changes to the annual statements, but still implement the prior recommendations of the Accident and Health Working Group.

Mike Batte (NM) moved, John Hartnedy (AR) seconded and the working group agreed to forward the recommendations with the proposed revisions to the Statutory Accounting (E) Principles Working Group. The final memo to the Statutory Accounting Principles (E) Working Group is Attachment Twelve-A.

Applicable excerpts from Attachment Twelve-A to the minutes of the March 23, 2001, meeting of the Accident and Health Working Group of the Life and Health Actuarial Task Force are included herein:

The Accident and Health Working Group (A&HWG) addressed cost containment expenses in a Sept. 11, 2000, memorandum to the Statutory Accounting Principles Working Group. This document is Attachment Seven-B of the Sept. 8, 2000 minutes of the Accident and Health Working Group and may be found on pages 160-162 of the Sept. 2000 Life & Health Actuarial Subscription.

In that memorandum, nine items were identified that could be considered cost containment expenses. Those nine items were further divided into two groupings. One grouping included the following expenses:

1. Clinical quality assurance and other types of medical care quality improvement efforts.
2. Provider contracting and credentialing costs.
3. Consumer education not exclusively relating to health improvement, such as newsletters and e-mails designed to provide health improvement ideas.

Another grouping identified in the Sept. 11 memorandum included the following expenses:

1. Case management activities.
2. Concurrent utilization review.
3. Prospective utilization review.
4. Detection and prevention of payment for fraudulent requests for reimbursement.
5. Network access fees to Preferred Provider Organizations and other network-based health plans, including prescription drug networks.
6. Consumer education solely relating to health improvement and relying on the direct involvement of health personnel. This would include smoking cessation and disease management programs, and other programs that involve hands on medical education.
Claim Adjustment Expenses, Amendments to SSAP No. 55,
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These expenses reduce the number or cost of health services, which results in lower premiums or lower premium increases. These six expenses will be the only expenses referenced as “cost containment expenses” in this memorandum.

In the Sept. 11 memorandum, the A&HWG recommended that cost containment expenses, as identified above, be included as losses for statutory reporting purposes, and that quality assurance expenses not be included as losses for statutory reporting. The remainder of this memorandum addresses how the Sept. 11 recommendations may be implemented in the Health Blank and in the Life, Accident and Health Blank.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 55—Unpaid Claims, Losses and Loss Adjustment Expenses
EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as “marked changes” (new text underlined and deleted text struck-through):

SSAP No. 55 paragraph 6 c.:

c. Claim Adjustment Expenses for Accident and Health Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraphs 6 a. and 6 b. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses. Examples of expenses incurred in these activities are:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 6 c. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties and

(e) Supplies and postage.
Claim Adjustment Expenses, Amendments to SSAP No. 55,
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SSAP No. 55 paragraph 7 b.:

b. Claim Adjustment Expenses for Managed Care Reporting Entities: Costs expected to be incurred in connection with the adjustment and recording of accident and health claims defined in subparagraph 7 a. of this statement. Claim adjustment expenses, including legal expenses, can be subdivided into cost containment expenses and other claim adjustment expenses. Examples of expenses incurred in these activities are:

i. Cost containment expenses: Expenses that actually serve to reduce the number of health services provided or the cost of such services. The following are examples of items that shall be considered “cost containment expenses” only if they result in reduced levels of costs or services:

(a) Case management activities;

(b) Utilization review;

(c) Detection and prevention of payment for fraudulent requests for reimbursement;

(d) Network access fees to Preferred Provider Organizations and other network-based health plans (including prescription drug networks), and allocated internal salaries and related costs associated with network development and/or provider contracting;

(e) Consumer education solely relating to health improvement and relying on the direct involvement of health personnel (this would include smoking cessation and disease management programs, and other programs that involve hands on medical education); and

(f) Expenses for internal and external appeals processes.

ii. Other claim adjustment expenses: Claim adjustment expenses as defined in paragraph 7 b. that are not cost containment expenses. Examples of other claim adjustment expenses are:

(a) Estimating the amounts of losses and disbursing loss payments;

(b) Maintaining records, general clerical, and secretarial;

(c) Office maintenance, occupancy costs, utilities, and computer maintenance;

(d) Supervisory and executive duties; and

(e) Supplies, and postage.
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Statutory Issue Paper No. 118

Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46

STATUS:
Finalized December 9, 2002

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish statutory accounting principles for investments in subsidiaries, controlled and affiliated entities (hereinafter referred to as SCA entities) that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper replaces the conclusions reached in SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46) and nullifies the following interpretations of the Emerging Accounting Issues Working Group:
   a. INT 99-03 – Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company
   b. INT 99-28 – Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46
   c. INT 00-01 – Investment in a Foreign SCA Entity
   d. INT 01-22 – Use of Interim Financial Statements in Computing Reporting Entity’s Investment in Subsidiary Under the GAAP Equity Method (conclusion was incorporated into SSAP)
   e. INT 01-24 – Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities

SUMMARY CONCLUSION

Definitions

3. The interpretations of the Emerging Accounting Issues Working Group, which interpret SSAP No. 46 that are affected by the new SSAP, which will be the result of this issue paper, will be identified in the new SSAP.

4. Parent and subsidiary are defined as follows:
   a. Parent—An entity that directly or indirectly owns and controls the reporting entity;
b. Subsidiary—An entity that is, directly or indirectly, owned and controlled by the reporting entity.

5. An affiliate is defined as an entity that is within the holding company system or a party that, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with the reporting entity. An affiliate includes a parent or subsidiary and may also include partnerships, joint ventures, and limited liability companies as defined in SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies (SSAP No. 48). Those entities are accounted for under the guidance provided in SSAP No. 48, which requires an equity method for all such investments.

6. Control is defined as the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the investee, whether through the (a) ownership of voting securities, (b) by contract other than a commercial contract for goods or nonmanagement services, (c) by common management, or (d) otherwise. Control shall be presumed to exist if a reporting entity and its affiliates directly or indirectly, own, control, hold with the power to vote, or hold proxies representing 10% or more of the voting interests of the entity.

7. The 10% ownership threshold shall be measured at the holding company level. For example, if one member of an affiliated group has a 5% interest in an entity and a second member of the group has an 8% interest in the same entity, the total interest is 13% and therefore each member of the affiliated group shall be presumed to have control. These presumptions can be overcome by predominant evidence to the contrary, however, they shall stand until overcome by such predominant contradictory evidence. FASB Interpretation No. 35, Criteria for Applying the Equity Method of Accounting for Investments in Common Stock, an Interpretation of APB Opinion No. 18, provides guidance on determining when such evidence exists. A reporting entity with 10% or more of the voting interest shall evaluate all facts and circumstances relating to the investment and reach a judgment about whether the presumption of control is overcome. The corollary is required to demonstrate control when a reporting entity owns less than 10% of the voting interest of an investee.

8. Investments in SCA entities meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this issue paper.

**Applying the Market Valuation, Audited Statutory Equity and Audited GAAP Equity Methods**

9. The admitted investments in SCA entities shall be recorded using either the market valuation approach (as described in paragraph 9 a.), or one of the equity methods (as described in paragraph 9 b.).

   a. In order to use the market valuation approach for SCA entities, the following requirements apply:

      i. The subsidiary must be traded on one of the following three major exchanges: (1) the New York Stock Exchange, (2) the American Stock Exchange, or (3) the NASDAQ National exchange;

      ii. The reporting entity must submit subsidiary information to the Securities Valuation Office (SVO) for its calculation of the subsidiary’s market value. Such calculation could result in further discounts in market value above the established base discounts based on ownership percentages detailed below;
iii. Ownership percentages for determining the discount rate shall be measured at the holding company level;

iv. If an investment in a SCA results in an ownership percentage between 10% and 50%, a base discount percentage between 0% and 20% on a sliding scale basis is required;

v. If an investment in a SCA results in an ownership percentage greater than 50% up to and including 80%, a base discount percentage between 20% and 30% on a sliding scale basis is required;

vi. If an investment in a SCA results in an ownership percentage greater than 80% up to and including 85%, a minimum base discount percentage of 30% is required.

vii. Further, the SCA must have at least two million shares outstanding, with a total market value of at least $50 million in the public’s control; and

viii. Any ownership percentages exceeding 85% will result in the SCA being recorded on an equity method.

b. If a SCA investment does not meet the requirements for the market valuation approach in paragraph 9 a. or, if the requirements are met, but a reporting entity elects not to use that approach, the reporting entity's proportionate share of its investments in SCAs shall be recorded as follows:

i. Investments in U.S. insurance SCA entities shall be recorded based on the underlying audited statutory equity of the respective entity’s financial statements, adjusted for any unamortized goodwill as provided for in SSAP No. 68—Business Combinations and Goodwill (SSAP No. 68). Reporting entities shall record investments in U.S. insurance SCA entities on at least a quarterly basis, and shall base the investment value on the most recent quarterly information available from the SCA. Entities may recognize their investment in U.S. insurance SCA entities based on the unaudited statutory equity in the SCAs year-end Annual Statement if the annual SCA audit is not complete as of the filing deadline. The recorded statutory equity shall be adjusted for audit adjustments, if any, as soon as the annual audit has been completed. Annual consolidated audits are allowed if completed in accordance with the Model Regulation Requiring Annual Audited Financial Reports as adopted by the SCA’s domiciliary state;

ii. Investments in noninsurance SCA entities that are engaged in the following transactions or activities:

(a) Collection of balances as described in SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers

(b) Sale/lease or rental of EDP Equipment and Software as described in SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP No. 79—Depreciation of Nonoperating System Software
(c) Sale/lease or rental of furniture, fixtures, equipment or leasehold improvements as described in SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements

(d) Loans to employees, agents, brokers, representatives of the reporting entity or SCA as described in SSAP No. 20—Nonadmitted Assets

(e) Sale/lease or rental of automobiles, airplanes and other vehicles as described in SSAP No. 20—Nonadmitted Assets

(f) Providing insurance services on behalf of the reporting entity including but not limited to accounting, actuarial, auditing, data processing, underwriting, collection of premiums, payment of claims and benefits, policyowner services

(g) Acting as an insurance or administrative agent or an agent for a government instrumentality performing an insurance function (e.g. processing of state workers compensations plans, managing assigned risk plans, Medicaid processing etc).

(h) Purchase or securitization of acquisition costs

and if 20% or more of the SCA’s revenue is generated from the reporting entity and its affiliates, then the underlying equity of the respective entity’s audited Generally Accepted Accounting Principles (GAAP) financial statements shall be adjusted to a statutory basis of accounting (refer to paragraph 10). For purposes of this section, revenue means GAAP revenue reported in the audited GAAP financial statements excluding realized and unrealized capital gains/losses. Paragraphs 18 through 20 provide guidance for investments in holding companies;

iii. Investments in noninsurance SCA entities that do not qualify under subparagraph 9 b. ii. shall be recorded based on the audited GAAP equity of the investee;

iv. Investments in foreign insurance SCA entities shall be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 10 and adjusted for reserves of the foreign insurance SCA with respect to the business it assumes directly and indirectly from a U.S. insurer using the statutory accounting principles promulgated by the NAIC in the Accounting Practices and Procedures Manual.

The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the annual audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standard No. 69, The Meaning of “Presents Fairly in Conformity With GAAP”. Foreign SCA entities are defined as those entities incorporated or otherwise legally formed under the laws of a foreign country. Foreign insurance SCA entities are defined as alien insurers formed according to the legal
requirements of a foreign country. Investments in foreign noninsurance SCA entities shall follow the
guidance in 8 b. ii., and 8 b. iii. above.

10. Statutory basis for accounting for investments in noninsurance SCA entities, subject to paragraph
9 b. ii. and foreign insurance SCA entities, subject to paragraph 9 b. iv., shall be based on the underlying
audited U.S. GAAP equity of the respective entity with the following adjustments:

a. Nonadmit assets pursuant to the following statutory accounting principles as promulgated
  by the NAIC in the Accounting Practices and Procedures Manual;
  i. SSAP No. 6—Uncollected Premium Balances, Bills Receivable for Premiums,
     and Amounts Due From Agents and Brokers
  ii. SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements
       Paid by the Reporting Entity as Lessee; Depreciation of Property and
       Amortization of Leasehold Improvements
  iii. SSAP No. 20—Nonadmitted Assets
  iv. SSAP No. 29—Prepaid Expenses
  v. SSAP No. 16—Electronic Data Processing Equipment and Software
  vi. SSAP No. 79—Depreciation of Nonoperating System Software

b. Expense costs that are capitalized in accordance with GAAP but are expensed pursuant to
   statutory accounting as promulgated by the NAIC in the Accounting Practices and
   Procedures Manual (e.g., deferred policy acquisition costs);

c. Adjust depreciation for certain assets in accordance with the following statutory
   accounting principles:
   i. SSAP No. 16—Electronic Data Processing Equipment and Software and SSAP
      No. 79, Depreciation of Nonoperating System Software
   ii. SSAP No. 19—Furniture, Fixtures and Equipment; Leasehold Improvements
       Paid by the Reporting Entity as Lessee; Depreciation of Property and
       Amortization of Leasehold Improvements

d. Nonadmit the amount of goodwill of the SCA in excess of 10% of the audited GAAP
   equity of the SCA’s last audited financial statements.

e. Nonadmit amount of the net deferred tax assets (DTAs) of the SCA in excess of 10% of
   the audited GAAP equity of the SCA’s last audited financial statements.

f. Adjust the GAAP annuity account value reserves of a foreign insurance SCA, with
   respect to the business it wrote directly, using the commissioners' annuity reserve
   valuation method (CARVM) as defined in paragraphs 12 and 13 of Appendix A-820
   (including the reserving provisions in the various Actuarial Guidelines which support
   CARVM). The valuation interest rate and mortality tables to be used in applying
   CARVM should be that prescribed by the foreign insurance SCA’s country of domicile. If
   the Foreign SCA’s country of domicile does not prescribe the necessary tables and/or
   rates, no reserve adjustment shall be made.
11. The recorded GAAP equity shall be adjusted for any audit adjustments resulting from either the annual GAAP audit of the respective entity or, if the entity is a member of a consolidated group of insurers, the audit of the consolidated group of companies, as soon as determined. GAAP is defined as those pronouncements included in the United States GAAP Hierarchy as described in AICPA Statement of Auditing Standards No. 69, The Meaning of “Presents Fairly in Conformity With GAAP.” The statutory equity method as described in paragraph 9 b. i., 9 b. ii. and 9 b. iii. shall be applied by recording an initial and subsequent investment in an investee at cost (excluding any investment in an investee’s surplus notes), which is defined in SSAP No. 68 as the sum of (a) any cash payment, (b) the fair value of other assets distributed, (c) the fair value of any liabilities assumed, and (d) any direct costs of the acquisition. After the date of acquisition, the investment amount shall be adjusted for the amortization of goodwill and the reporting entity’s share of the change in special surplus funds, other than special surplus funds and unassigned funds (surplus), as defined in SSAP No. 72—Surplus and Quasi-reorganizations. This represents the carrying amount of the investment.

12. Once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method to another method without the approval of the domiciliary commissioner. For instance, if an entity selects the market valuation method, it may not change to an equity method or vice versa without approval from the domiciliary commissioner. The only exception to this notification requirement is the case in which an investment in a SCA entity that was previously accounted for under one method no longer qualifies under that method because of a change in the level of ownership, (i.e., acquisition of additional interests by the reporting entity) acquisition or retirement of interests by the investee, or a change in facts or circumstances (e.g., paragraphs 9 a. i., 9 a. vii.). Further, in order for an entity to transfer from a paragraph 9 a., 9 b. ii. or 9 b. iii. valuation to a paragraph 9 b. iv. valuation, the SCA shall not exceed the 20% threshold (as defined in paragraphs 9 b. ii. and 9 b. iii.) for three consecutive years. When an investment qualifies for use of another method of accounting, the reporting entity shall adopt the new method of accounting and the investment shall be adjusted to reflect the reporting entity’s equity interest in the SCA entity under the new method. A corresponding amount shall be recorded as an unrealized gain or loss.

13. If the reporting entity is using an equity method, the reporting entity’s share of undistributed earnings and losses of the investee shall be included in unrealized gains and losses of the reporting entity. The reporting entity’s share of other changes in the investee’s surplus (e.g., the change in the investee’s nonadmitted assets) shall be recorded by the investor as a component of unrealized capital gains and losses on investments. If the reporting entity uses the market valuation approach outlined in paragraph 9 a., changes in that valuation shall be included in unrealized gains and losses. Dividends or distributions received from an investee shall be recognized in investment income when declared to the extent that they are not in excess of the undistributed accumulated earnings attributable to the investee. Dividends or distributions declared in excess of the undistributed accumulated earnings attributable to the investee shall reduce the carrying amount of the investment.

14. For investments in entities recorded based on the underlying audited GAAP equity of the investee, the amount to be recorded shall be defined as the initial investment in an investee at cost (as defined in SSAP No. 68). The carrying amount of the investment shall be adjusted to recognize the reporting entity’s share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. A reporting entity’s share of adjustments that are recorded directly to the investee’s stockholder’s equity under GAAP shall also be recorded as adjustments to the carrying value of the investment with an offsetting amount recorded directly to unrealized capital gains and losses on investments.
15. On at least a quarterly basis, the procedures set forth below shall be followed by a reporting entity in applying an equity method of accounting (as described in paragraphs 9 b. i. through 9 b. iv.), as applicable, to investments in SCA entities:

a. A difference between the cost of an investment and the underlying equity in the statutory or GAAP book value, as applicable, of the acquired company at the date of acquisition shall be accounted for in accordance with SSAP No. 68;

b. A transaction of an investee of a capital nature that affects the reporting entity’s share of stockholders’ equity of the investee shall be reflected as an unrealized gain or loss (e.g., where the investee issues additional stock or a new class of stock that impacts the reporting entity’s equity ownership in the investee, the reporting entity’s recorded investment shall be adjusted to reflect the transaction);

c. Realized gains or losses on the sale of an investment in a SCA entity shall be recorded in an amount equal to the difference at the time of sale between the selling price and carrying amount of the investment plus any previously recorded unrealized gain or loss;

d. If financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee’s current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period;

e. A reporting entity’s share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by an equity method plus advances made by the investor. The reporting entity shall discontinue applying an equity method when the investment (including advances) is reduced to zero and shall not provide for additional losses unless the reporting entity has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee (guaranteed obligations meeting the definition of liabilities in SSAP No. 5—Liabilities, Contingencies and Impairments of Assets shall be recorded as liabilities). If the investee subsequently reports net income, the reporting entity shall resume applying an equity method only after its share of that net income equals the share of net losses not recognized during the period that an equity method was suspended;

f. When an investee has outstanding cumulative preferred stock, the reporting entity shall compute its share of earnings (losses) after deducting the investee’s preferred dividends, whether or not such dividends are declared;

g. An investment in a SCA entity may fall below the level of ownership described in paragraph 6 from the sale of a portion of an investment by the reporting entity, the sale of additional interests by an investee, or other transactions. The reporting entity shall discontinue accruing its share of the earnings or losses of the investee for an investment that no longer qualifies for an equity method. The earnings or losses that relate to the investment interests retained by the reporting entity and that were previously accrued shall remain as a part of the carrying amount of the investment. The investment account shall not be adjusted retroactively under the conditions described in this subparagraph. However, dividends received by the investor in subsequent periods which exceed the
reporting entity’s share of earnings for such periods shall be applied as a reduction of the carrying amount of the investment.

16. A reporting entity that owns an interest in itself via direct ownership of shares of an upstream intermediate or ultimate parent shall reduce the value of such shares for the reciprocal ownership. If the shares of the parent are owned indirectly by a reporting entity, via a downstream SCA entity, the directly held entity, which owns the parent’s shares, shall have its value reduced for the reciprocal ownership.

17. Any parent reporting entity that owns an interest in itself via either direct or indirect ownership of a downstream affiliate, which in turn owns shares of the parent reporting entity, shall eliminate its proportionate interest in these shares from the valuation of such affiliate.

Investments in Holding Companies

18. Valuation of a holding company depends upon the nature of the SCA entities it holds in accordance with paragraph 9 and the guidance contained in the applicable SSAP for non-SCA investments. If an SCA investment of the holding company does not meet the provisions of paragraph 9 a. or if it elects not to use the guidance in paragraph 9 a., and instead uses the guidance in paragraph 9 b., then the holding company would look to its underlying assets and record them as follows:

   a. Investments by a holding company in insurance SCA entities are recorded based upon the guidance in paragraph 9 b. i.;

   b. Investments by a holding company in noninsurance SCA entities that primarily provide services or hold assets that are for the direct or indirect use of the reporting entity or its affiliates are recorded based upon the guidance in paragraph 9 b. ii. or 9 b. iii. as applicable;

   c. Investments by a holding company in noninsurance SCA entities that do not qualify under paragraph 18 b. above shall be recorded based upon the guidance in paragraph 9 b. iii.; and

   d. Investments by a holding company in foreign insurance and noninsurance SCA entities shall be recorded based upon the guidance in paragraphs 9 b. iv. above.

19. In lieu of separate GAAP audits of SCA entities of the holding company, the insurer can choose to have a GAAP audit performed at the holding company level with a consolidating balance sheet showing GAAP equity of all the SCA entities. The consolidating balance sheet shall then be adjusted for GAAP to SAP differences of the insurance entities and paragraph 9 b. ii. 9 b. iii. and 9 b. iv. entities under the holding company. This adjusted amount would then be the reported value of the investment in holding company at the higher level insurance company.

20. A purchased holding company is valued in accordance with the provisions above and the provisions of SSAP No. 68.

Investment in Preferred Stock or Surplus Notes of a Subsidiary, Controlled and Affiliated Entity

21. When the reporting entity also holds an investment in preferred stock or surplus note(s) of an SCA and the carrying amount determined in accordance with paragraphs 9 b. and 10 includes preferred stock or surplus note(s), the investment in the SCA must be separated into its components. The carrying amount of the SCA is reduced by the value of the SCA’s preferred stock or surplus note(s).
22. Investments in the preferred stock of an SCA shall be accounted for and reported in accordance with the provisions of SSAP No. 32—*Investments in Preferred Stock* (SSAP No. 32). This statement amends the title of SSAP No. 32 as follows:

*SSAP No. 32—Investments in Preferred Stock* (including excluding investments in preferred stock of subsidiary, controlled, or affiliated entities)

This statement amends paragraphs 2 and 3 of SSAP No. 32 to the following:

2. Investments in preferred stock of subsidiaries, controlled or affiliated entities are included within the scope of this statement.

3. Preferred stock (including investment in affiliates), which may or may not be publicly traded and may include shares against which exchange traded call options are outstanding, shall include:

23. Investments in the surplus notes of an SCA shall be accounted for and reported in accordance with the provisions of SSAP No. 41—*Surplus Notes*.

24. The following example is provided to illustrate the accounting and reporting. The reporting entity holds 100% of the preferred stock. The SCA issued the preferred stock for $50,000. The investment in the SCA, measured in accordance with this SSAP is $250,000 including the preferred stock of the SCA. The investment in the SCA is $200,000 ($250,000-50,000) and the preferred stock is measured and reported in accordance with SSAP No. 32.

**Impairment**

25. When there is a decline in the fair value of an asset owned by a SCA entity that is other than temporary, the SCA entity shall write the asset down to fair value.

26. For any decline in the fair value of an investment in a SCA entity that is other than temporary, the investment shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. The write down shall first be considered as an adjustment to any portion of the investment that is nonadmitted (e.g., goodwill). The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value, which are determined to be other than temporary shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to recover the carrying amount of the investment or there is evidence indicating inability of the investee to sustain earnings, which would justify the carrying amount of the investment. A fair value of an investment that is below the carrying amount based on the statutory equity method or the existence of investee operating losses may indicate a loss in value, however, they are not necessarily indicative of a loss in value that is other than temporary.

**Consolidation**

27. Majority-owned subsidiaries shall not be consolidated for individual entity statutory reporting. This does not exempt certain reporting entities that are members of an affiliated group from the requirement to issue consolidated or combined annual statements as supplemental information in accordance with NAIC guidelines.

**Disclosures**
28. The significance of an investment to the reporting entity’s financial position and results of operations shall be considered in evaluating the extent of disclosures of the financial position and results of operations of an investee. The following disclosures shall be made for all investments in SCA entities that exceed 10% of the total admitted assets of the reporting entity:

   a. Financial statements of a reporting entity shall disclose (i) the name of each SCA entity and percentage of ownership of common stock, (ii) the accounting policies of the reporting entity with respect to investments in SCA entities, and (iii) the difference, if any, between the amount at which the investment is carried and the amount of underlying equity in net assets (i.e., goodwill, other nonadmitted assets, market value or discounted market value adjustments) and the accounting treatment of the difference;

   b. For those SCA entities for which a quoted market price is available, the aggregate value of each SCA investment based on the quoted market price and the difference, if any, between the amount at which the investment is carried and the quoted market price shall be disclosed;

   c. Summarized information as to assets, liabilities, and results of operations shall be presented for SCA entities, either individually or in groups;

   d. Conversion of outstanding convertible securities, exercise of outstanding options and warrants and other contingent issuances of an investee may have a significant effect on an investor’s share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises or contingent issuances shall be disclosed in notes to the financial statements of the reporting entity; and

   e. For those SCA entities in which the reporting entity elected, or was required to change its valuation method as described in paragraph 12, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses shall be disclosed. The entity shall also disclose whether commissioner approval was obtained in accordance with paragraph 12.

29. Any commitment or contingent commitment to a SCA entity shall be disclosed (e.g., guarantees or commitments to provide additional capital contributions).

30. A reporting entity that recognizes an impairment loss shall disclose the following in the financial statements that include the period of the impairment write down:

   a. A description of the impaired assets and the facts and circumstances leading to the impairment; and

   b. The amount of the impairment and how fair value was determined.

31. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures in paragraph 28 d. above shall be included in the annual audited statutory financial reports only.

**Effective Date and Transition**
32. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years ending on or after December 31, 2004.

DISCUSSION

33. This issue paper replaces the conclusions reached in SSAP No. 46. The amendments to SSAP No. 46 included in this issue paper are considered substantive by the Statutory Accounting Principles Working Group as they replace the judgment in determining application of statutory equity method versus the audited GAAP equity with a specific “bright-line” test. The following represents the substantive changes from SSAP No. 46 that are included in this issue paper:

<table>
<thead>
<tr>
<th>SSAP No. 46 Paragraph</th>
<th>IP 118 No. Paragraph</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 and 13 h</td>
<td>12</td>
<td>Retains guidance from SSAP No. 46 but includes a specific requirement in order to transfer from a noninsurance market or statutory equity method to an audited GAAP method.</td>
</tr>
<tr>
<td>7 b. i.</td>
<td>9 b. i.</td>
<td>Adds an audit requirement.</td>
</tr>
<tr>
<td>7 b. ii.</td>
<td>9 b. ii. and 9 b. iii.</td>
<td>Removes ambiguous language related to “significant ongoing operations” with a bright-line test.</td>
</tr>
<tr>
<td>7 b. iii.</td>
<td>9 b. ii.</td>
<td>Removes ambiguous language related to “significant ongoing operations” with default position.</td>
</tr>
<tr>
<td>-</td>
<td>9 b. iv.</td>
<td>New language included for investments in foreign SCA entities.</td>
</tr>
<tr>
<td>8</td>
<td>-</td>
<td>Paragraph removed in its entirety. This paragraph was interpreted to be in conflict with paragraph 7 of SSAP No. 46.</td>
</tr>
<tr>
<td>11</td>
<td>9 and 10</td>
<td>Language from SSAP No. 46 moved to paragraphs 9 and 10 of issue paper to provide further clarity.</td>
</tr>
<tr>
<td>13 a.</td>
<td>15 a.</td>
<td>References to noninsurance SCA as defined in SSAP No. 46 paragraph 7 b. ii. removed as definition of such SCA was modified by this issue paper.</td>
</tr>
<tr>
<td>-</td>
<td>28 e.</td>
<td>New disclosure related to change in valuation method was added.</td>
</tr>
</tbody>
</table>

34. This issue paper nullifies the following interpretations of the Emerging Accounting Issues Working Group:

a. INT 99-03 – Accounting for Investment in Subsidiary, Controlled or Affiliated Entities with Subsequent Downstream Investment in an Insurance Company is nullified because INT 01-06 provided for a more descriptive application for holding companies. As this
issue paper incorporates the guidance in INT 01-06, the conclusions reached in INT 99-3 are no longer necessary.

b. INT 99-28 – Accounting for SCA Mutual Funds, Broker-Dealers and Similar Entities Under SSAP No. 46 is nullified because there is no longer a need to differentiate certain SCA investments as the term “significant operations” has now been defined.

c. INT 00-01 – Investment in a Foreign SCA Entity is nullified by the conclusions reached in paragraph 9 b. iv.

d. INT 01-24 – Application of SSAP No. 46 and 48 to Certain Noninsurance Subsidiary, Controlled or Affiliated Entities is nullified by the conclusions reached in paragraph 9 and Exhibit A.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

35. See Issue Paper No. 46 for statutory references.

Generally Accepted Accounting Principles

36. See Issue Paper No. 46 for GAAP references.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 46—Investments in Subsidiary, Controlled and Affiliated Entities

Generally Accepted Accounting Principles
- See Issue Paper No. 46 for GAAP references.

State Regulations
- No additional guidance obtained from state statutes or regulations
EXHIBIT A – ILLUSTRATIVE EXAMPLES FOR PROVISION OF PARAGRAPH 9 b.

Example 1:
Insurance Company A owns 100% of a third party administrator, TPA1. TPA1 processes claims for noninsurance companies and for Medicare and Medicaid programs. TPA1 is completely independent from Insurance Company A and as such does not receive any management income or lease income from Insurance Company A or its affiliates. TPA1 does not process claims for Insurance Company A.

Equity Method – Insurance Company A would value TPA1 under 9 b. iii. (audited GAAP equity) as TPA1’s revenue from Insurance Company A is less than 20%.

Example 2:
Insurance Company A owns 100% of a company that processes insurance claims, TPA2. TPA2 processes claims for Insurance Company A, Insurance Company B, Insurance Company C and Insurance Company D. TPA2 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Companies B, C and D are not affiliates of Insurance Company A. The processing of claims for Insurance Company A constitutes 15% of the revenues of TPA2.

Equity Method – Insurance Company A would value TPA2 under 9 b. iii. (audited GAAP equity) as TPA2’s revenue from Insurance Company A is less than 20%.

Example 3:
Insurance Companies A, B, C and D each own 25% of a company, TPA3, that provides administrative services, including all EDP processing, to Insurance Companies A, B, C and D. TPA3 owns the EDP equipment and software and furniture, fixtures and equipment necessary to provide administrative services to its customers. TPA3 does not provide administrative services to any other entities. Insurance Companies A, B, C and D are not part of the same insurance holding company system. The processing that TPA3 does for each of Insurance Companies A, B, C and D constitutes 25% of its business and revenues.

Equity Method – Insurance Company A, B, C and D would value TPA3 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA3’s revenue from each Insurance Company A, B, C and D is greater than 20%.

Example 4:
Insurance Company A owns 100% of a company, TPA4, that provides administrative services, including EDP processing, to Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D. TPA4 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B, Bank C and Manufacturing Company D are not affiliates, i.e. none of the four companies are related to one another. The processing that TPA4 does for Insurance Company A represents 40% of TPA4’s business and revenues.

Equity Method – Insurance Company A would value TPA4 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4’s revenue from Insurance Company A is greater than 20%.

Example 5:
Insurance Company A owns 100% of a company, TPA5, that provides claims administration services, including EDP processing, to Insurance Company A, Insurance Company B, numerous self-insured companies and Medicare. TPA5 owns the EDP equipment and software necessary to provide administrative services to its customers. Insurance Company A, Insurance Company B and the self-
insured companies are not affiliates, i.e., they are not related to one another. Insurance Companies A and B may provide stop-loss coverage to some of the self-insured companies for whom TPA5 provides claims administration services. The processing that TPA5 does for Insurance Company A represents 51% of TPA5’s business and revenues.

Equity Method – Insurance Company A would value TPA5 under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as TPA4’s revenue from Insurance Company A is greater than 20%.

Example 6:
Insurance Company A holds an 18.77% Partnership Interest in LPA. This fund was organized for the primary purpose of investing in investment vehicles and commodity pools as a “fund of funds” investment manager. The insurer is a limited partner. The general partner is not affiliated with the insurer. Quoting from the limited partnership agreement Section 3.1 – “The general partner shall be vested with the complete control of the business of the fund. The limited partners shall have no responsibility for the management of the fund and shall have no authority or right to act on behalf of the fund or to bind the fund in connection with any matter.” The largest holding on their 12/31/99 audited GAAP financials was $293.6 million of “Investments in limited partnerships and investment funds, at fair value.” Beyond that they have $28.0 million of cash and cash equivalents and $90k of dividends and interest receivable.

Equity Method – Insurance Company A would value LPA under 9 b. iii. (audited GAAP equity) as less than 20% of LPA’s investment income is for the benefit of Insurance Company A.

Example 7:
Insurance Company A holds a 25% Partnership Interest in LPB. Similar to the LPA above, LPB is another limited partnership investment where the insurer owns greater than a 10% interest. The LP fund was organized primarily for the purpose of making investments in media businesses. The fund’s general partner is not affiliated with the insurer. The general partner manages all of the affairs of the fund, i.e., controls the business activities of the fund. The largest holding on their 12/31/99 unaudited GAAP financials (assume for this example that audited statements are not and will not be prepared) was $194.0 million of “Portfolio investments at fair value.” This was made up of a combination of partnership and stock investments. Total assets were $200.8 million at 12/31/99.

Equity Method – Insurance Company A would value LPB under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LPB is for the benefit of Insurance Company A.

Example 8:
Insurance Company A holds a 25% Partnership Interest in LLP. LLP is a real estate development limited partnership in which the insurer holds a 25% interest as a limited partner. The LLP’s general partner is not affiliated with the insurer. The general partner manages the affairs of partnership including decisions on properties to acquire and/or develop. Assets of the partnership include real estate properties, both residential and commercial. Total assets of the partnership are $1 billion and total liabilities $500 million, primarily outside debt. LLP prepares annual audited GAAP financial statements, however, they are not completed prior to the insurer filing its annual financial statements.

Equity Method – Insurance Company A would value LLP under 9 b. ii. (audited GAAP equity adjusted to SAP or audited SAP equity) as more than 20% of the investment income of LLP is for the benefit of Insurance Company A.
Statutory Issue Paper No. 119

Capitalization Policy, An Amendment to SSAP Nos. 4, 19, 29, 73, 79 and 82

STATUS
Finalized June 10, 2002

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. The purpose of this issue paper is to establish a statutory capitalization policy that is consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

2. This issue paper amends certain conclusions reached in SSAP No. 4–Assets and Nonadmitted Assets (SSAP No. 4), SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements (SSAP No. 19), SSAP No. 29–Prepaid Expenses (SSAP No. 29), SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities (SSAP No. 73), SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software (SSAP No. 79) and SSAP No. 82–Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs (SSAP No. 82).

RECOMMENDED CONCLUSION

3. In general, this issue paper amends the phrase “in accordance with the reporting entity's capitalization policy, immaterial amounts … can be expensed …” to “in accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold … shall be expensed …”. A predefined threshold shall be established, for each asset class identified by SSAP Nos. 19, 29, 73, 79 and 82, by management based upon an analysis of circumstances unique to the entity and shall not be adjusted from period to period except under extenuating circumstances. If an entity demonstrates a pattern of varying its capitalization policy from period to period without sufficient evidence as determined by the reporting entity’s domestic regulator, such action would call into question both the entity's ability to accurately establish a predefined threshold and the propriety of expensing or capitalizing certain assets. Accordingly, entities shall expense all immaterial amounts (i.e., entity is no longer allowed to establish its own capitalization policy).

4. This issue paper amends paragraph 3 of SSAP No. 4 to the following:

As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting
principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or

If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, shall be expensed when purchased.

5. This issue paper amends paragraphs 3 and 6 of SSAP No. 19 to the following:

In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of such assets shall be expensed when purchased.

6. This issue paper amends paragraph 3 of SSAP No. 29 to the following:

In accordance with the reporting entity's capitalization policy, prepaid expenses less than a predefined threshold shall be expensed when purchased.

7. This issue paper amends paragraph 10 of SSAP No. 73 to the following:

In accordance with the reporting entity's capitalization policy, amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements shall be expensed when purchased.

8. This issue paper amends paragraph 4 of SSAP No. 79 to the following:

In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold shall be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

9. This issue paper amends paragraph 4 of SSAP No. 82 to the following:

In accordance with the reporting entity’s capitalization policy, amounts less than a predefined threshold of such costs shall be expensed when incurred.

10. The reporting entity shall maintain a capitalization policy containing the predefined thresholds for each asset class to be made available for the department(s) of insurance.
Disclosures
11. The financial statements shall disclose if the written capitalization policy and the resultant predefined thresholds changed from the prior period and the reason(s) for such change.

Effective Date and Transition
12. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will contain an effective date of years beginning on or after January 1, 2004.

DISCUSSION
13. This issue paper replaces the subjectivity associated with capitalizing assets based upon materiality with a more quantifiable concept of capitalizing assets above a predefined threshold. This amendment is in harmony with the principle of consistency found in the Statement of Concepts. That is, the concept of materiality used in previous SSAPs was subject to interpretation and manipulation from period to period whereas the predefined threshold model used in this issue paper provides a definitive benchmark that can be quantified and judged from period to period. This issue paper requires entities to disclose their threshold, explain how they reached their threshold and offer support if they modify their capitalization policy. Previous statements, due to the subjective nature of expensing immaterial amounts, did not require this disclosure. The issue paper also includes a penalty for entities that manipulate their capitalization policy from period to period. The NAIC believe this issue paper provides a more consistent and transparent capitalization framework than previous statements.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
14. SSAP No. 4 paragraph 3:

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy,
immaterial amounts of furniture, fixtures, equipment, or supplies, can be expensed when purchased.

15. SSAP No. 19 paragraphs 3 and 6:

3. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when purchased.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts of such assets can be expensed when acquired.

16. SSAP No. 29 paragraph 3:

3. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses may be expensed when purchased.

17. SSAP No. 73 paragraph 10:

10. In accordance with the reporting entity's capitalization policy, immaterial amounts of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.

18. SSAP No. 79 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, immaterial amounts may be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

19. SSAP No. 82 paragraph 4:

4. In accordance with the reporting entity's capitalization policy, immaterial amounts of such costs can be expensed when incurred.

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 4–Assets and Nonadmitted Assets
- SSAP No. 19–Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
- SSAP No. 29–Prepaid Expenses
- SSAP No. 73–Health Care Delivery Assets - Supplies, Pharmaceuticals and Surgical Supplies, Durable Medical Equipment, Furniture, Medical Equipment and Fixtures, and Leasehold Improvements in Health Care Facilities
- SSAP No. 79–Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16–Electronic Data Processing Equipment and Software
- SSAP No. 82– Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs
Generally Accepted Accounting Principles
- No guidance obtained from GAAP
EXHIBIT A: Illustration of Marked Changes to Amended SSAPs

The following depicts the amendments made by this issue paper as “marked changes” (new text underlined and deleted text struck-through):

**SSAP No. 4 paragraph 3:**

3. As stated in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet," and are, therefore, considered nonadmitted. For purposes of statutory accounting principles, a nonadmitted asset shall be defined as an asset meeting the criteria in paragraph 2 above, which is accorded limited or no value in statutory reporting, and is one which is:

   a. Specifically identified within the Accounting Practices and Procedures Manual as a nonadmitted asset; or


If an asset meets one of these criteria, the asset shall be reported as a nonadmitted asset and charged against surplus unless otherwise specifically addressed within the Accounting Practices and Procedures Manual. The asset shall be depreciated or amortized against net income as the estimated economic benefit expires. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of furniture, fixtures, equipment, or supplies, may be expensed when purchased.

**SSAP No. 19 paragraphs 3 and 6:**

3. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of such assets may be expensed when purchased.

6. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of such assets may be expensed when purchased.

**SSAP No. 29 paragraph 3:**

3. In accordance with the reporting entity's capitalization policy, immaterial prepaid expenses less than a predefined threshold may be expensed when purchased.

**SSAP No. 73 paragraph 10:**

10. In accordance with the reporting entity's capitalization policy, immaterial amounts less than a predefined threshold of medical supplies, pharmaceuticals and surgical supplies, durable medical equipment, furniture, medical equipment and fixtures, and leasehold improvements may be expensed when purchased.
SSAP No. 79 paragraph 4:

4. In accordance with the reporting entity’s capitalization policy, immaterial amounts less than a predefined threshold shall may be expensed when purchased, otherwise the assets shall be capitalized and depreciated in accordance with this statement.

SSAP No. 82 paragraph 4:

4. In accordance with the reporting entity’s capitalization policy, immaterial amounts less than a predefined threshold of such costs can shall be expensed when incurred.
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Statutory Issue Paper No. 122

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

STATUS
Adopted December 8, 2003

Type of Issue:
Common

SUMMARY OF ISSUE

1. Current statutory accounting guidance for transfers and servicing of financial assets and extinguishments of liabilities is provided in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SSAP No. 18). Current statutory accounting guidance for asset securitizations and securitizations of policy acquisition costs is provided in SSAP No. 33—Securitization (SSAP No. 33). Current statutory accounting guidance for repurchase agreements, reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements is provided in SSAP No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements (SSAP No. 45). SSAP No. 18, SSAP No. 33 and SSAP No. 45 adopted FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125) with modification for statutory accounting purposes. The modifications to FAS 125 primarily relate to:

   a. The nonadmission of servicing rights assets;
   b. The accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements;
   c. The accounting for realized gains and losses for reporting entities required to maintain an IMR;
   d. The accounting for financial assets subject to prepayment;
   e. The accounting for assets pledged as collateral;
   f. The accounting for leases in accordance with SSAP No. 22—Leases (SSAP No. 22);
   g. The accounting for sales of receivables with recourse; and
   h. Paragraph 14 of FAS 125 is rejected as it relates to classifications of securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 is rejected in SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities (SSAP No. 26).

2. In September 2000, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 140). FAS 140 replaces FAS 125. FAS 140 reconsiders or clarifies the guidance in FAS 125 concerning the following:

   a. Circumstances in which a special-purpose entity (SPE) can be considered qualifying;
b. Circumstances in which the assets held by a qualifying SPE should appear in the consolidated financial statements of the transferor;

c. Whether sale accounting is precluded if the transferor holds a right to repurchase transferred assets that is attached to, is embedded in, or is otherwise transferable with the financial assets;

d. Circumstances in which sale accounting is precluded if transferred financial assets can be removed from a SPE by the transferor (for example under a removal-of-accounts provision (ROAP);

e. Whether arrangements that obligate, but do not entitle, a transferor to repurchase or redeem transferred financial assets should affect the accounting for those transfers;

f. The impact of the powers of the Federal Deposit Insurance Corporation (FDIC) on isolation of assets transferred by financial institutions;

g. Whether transfers of financial assets measured using the equity method of accounting should continue to be included in the scope of FAS 125;

h. Whether disclosures should be enhanced to provide more information about assumptions used to determine the fair value of retained interests and the gain or loss on financial assets sold in securitizations; and

i. The accounting for and disclosure about collateral that can be sold or repledged.

3. The purpose of this issue paper is to establish statutory accounting principles for transfers and servicing of financial assets, including asset securitizations and securitizations of policy acquisition costs, extinguishments of liabilities, repurchase agreements and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). This issue paper discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this issue paper. Securitizations of nonfinancial assets are outside the scope of this issue paper.

RECOMMENDED CONCLUSION

4. See SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties (SSAP No. 25) for additional accounting and disclosure guidance concerning related party transactions. In addition the guidance for the following topics have been addressed in Interpretations of the Emerging Accounting Issues Working Group:

a. INT 99-22: EITF 98-8 Accounting for Transfers of Investments That Are in Substance Real Estate resolved this conflict between application of SSAP 40—Real Estate Investments and SSAP No. 18.

b. INT 99-21: EITF 98-7 Accounting for Exchanges of Similar Equity Method Investments resolved this conflict between application of SSAP No. 28—Nonmonetary Transactions and SSAP No. 18.

5. SSAP No. 18, SSAP No. 33 and SSAP No. 45 are superseded by the conclusions outlined in this issue paper.

6. This issue paper does not address the securitization of mortality or morbidity risk. The NAIC’s Insurance Securitization Working Group of the Financial Condition (E) Committee is charged with the
development of model laws, model regulations and proposed accounting guidance for the securitization of
mortality and morbidity risk. When such proposed accounting guidance is finalized the development of an
issue paper will be considered.

7. Except as discussed in paragraphs 57 and 89, a transfer of a group of financial assets, or a portion
of a financial asset in which the transferor surrenders control over those financial assets shall be
accounted for as a sale to the extent that consideration other than beneficial interests in the transferred
assets is received in exchange. The transferor has surrendered control over transferred assets if, and only
if, all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond
the reach of the transferor and its creditors, even in bankruptcy or other receivership (see
paragraphs 18 and 19);

b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking
advantage of that right (see paragraphs 20-24), to pledge or exchange the transferred
assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph
26 and the holders of beneficial interests in that entity have the right, free of conditions
that constrain them from taking advantage of that right (see paragraph 25), to pledge or
exchange those interests and no condition both constrains the transferee (or holder) from
taking advantage of its right to pledge or exchange and provide more than a trivial benefit
to the transferor; and

c. The transferor does not maintain effective control over the transferred assets through (i)
an agreement that both entitles and obligates the transferor to repurchase or redeem them
before their maturity (see paragraphs 39-41) or (ii) the ability to unilaterally cause the
holder to return specific assets, other than through a cleanup call (see paragraphs 23-24
and 42-46).

8. Upon completion of any transfer of financial assets, the transferor shall:

a. Continue to carry in its balance sheet any retained interest in the transferred assets,
including, if applicable, beneficial interests in assets transferred to a qualifying special-
purpose entity in a securitization, and retained undivided interests (see paragraphs 9 c.,
49 and 50); and

b. Allocate the previous carrying amount between the assets sold, if any, and the retained
interests, if any, based on their relative fair values at the date of transfer (see paragraphs
49 and 50).

9. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale
(see paragraph 7), the transferor (seller) shall:

a. Eliminate the transferred assets from the balance sheet;

b. Allocate the previous carrying amount of the transferred assets to the securities
representing beneficial interests retained by the reporting entity, if any, and the securities
representing beneficial interests not retained, if any, based on the relative fair values of
the transferred assets at the date of transfer;

c. Record in its balance sheet, the allocated carrying value of the securities representing
retained beneficial interests in the assets (e.g., loan-backed securities). Subsequent to the
transfer of assets:
i. Retained residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

ii. Retained beneficial interests shall be accounted for in accordance with the statutory accounting principles for the specific asset type (e.g., bonds shall be accounted for in accordance with SSAP No. 26, loan-backed securities shall be accounted for in accordance with SSAP No. 43—Loan-backed and Structured Securities, preferred stock in accordance with SSAP No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities).

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 9c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value (see Glossary), or if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraph 51); and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized and unrealized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve (SSAP No. 7). For reporting entities not required to maintain an IMR, realized capital gains and losses shall be reported as net realized capital gains or losses in the statement of income, and unrealized capital gains and losses shall be reported as net unrealized gains and losses in unassigned funds (surplus).

10. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

11. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements are described in paragraphs 68 - 78. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 92. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 7, or (b) is a sale of receivables with recourse (see paragraph 89); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 14).

**Recognition and Measurement of Servicing Assets and Liabilities**

13. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations in other income. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. The servicing asset or
liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

**Secured Borrowings and Collateral**

14. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

   The debtor shall reclassify that asset and report that asset in its balance sheet separately (for example, as security pledged to creditors) from other assets not so encumbered;

   The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

15. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. If the assets pledged are recorded as admitted assets under SSAP No. 4—Assets and Nonadmitted Assets (SSAP No. 4) and are not impaired under the provisions of SSAP No. 5—Liabilities, Contingencies and Impairments of Assets (SSAP No. 5), the pledging insurer records the collateral as an admitted asset until committing a contract default that has not been cured in accordance with the contract provisions. At the time of an uncured default, the provisions of paragraph 14 above shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset shall be removed from the balance sheet since that obligation has been satisfied through the secured party’s utilization of that collateral. To the extent that an uncured default remains without the
secured party utilizing the collateral to offset the obligation, the pledging insurer shall only record an
admitted asset for the amount of collateral that it can redeem.

**Extinguishments of Liabilities**

16. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15—
*Debt and Holding Company Obligations*). A liability has been extinguished if either of the following
conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the
creditor includes delivery of cash, other financial assets, goods, or services or
reacquisition by the debtor of its outstanding debt securities whether the securities are
canceled or held as so-called treasury bonds; or

b. The debtor is legally released from being the primary obligor under the liability, either
judicially or by the creditor.

17. If a creditor releases a debtor from primary obligation on the condition that a third party assumes
the obligation and that the original debtor becomes secondarily liable, that release extinguishes the
original debtor's liability. However, in those circumstances, whether or not explicit consideration was
paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a
guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that
creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee
obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss
recognized on extinguishment.

**Isolation Beyond the Reach of the Transferor and Its Creditors**

18. The nature and extent of supporting evidence required for an assertion in financial statements that
transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and
its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the
facts and circumstances. All available evidence that either supports or questions an assertion shall be
considered. That consideration includes making judgments about whether the contract or circumstances
permit the transferor to revoke the transfer. It also may include making judgments about the kind of
bankruptcy or other receivership into which a transferor or special-purpose entity might be placed,
whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is
affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of
transferred assets is appropriate only if the available evidence provides reasonable assurance that the
transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for
the transferor. Transactions between related parties or affiliates are accounted for in accordance with
SSAP No. 25.

19. Many common financial transactions, for example, typical repurchase agreements and securities
lending transactions, isolate transferred assets from the transferor, although they may not meet the other
criteria for surrender of control.

**Conditions That Constrain a Transferee**

20. Sale accounting is allowed under paragraph 7 only if each transferee has the right to pledge, or
the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right
also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a
transferred asset both constrain a transferee from pledging or exchanging the transferred assets and,
through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in
the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the
transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer’s business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

21. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor’s competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

22. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.

Transferor's Rights or Obligations to Reacquire Transferred Assets

23. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 7. For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 7.

24. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets, as discussed in paragraphs 42–46, thus precluding sale accounting under paragraph 7.
Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

25. The considerations in paragraphs 20-23, about conditions that may or may not constrain a transferee that is not a qualifying special-purpose entity (SPE) from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a beneficial interest holder (BIH) from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

26. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraphs 27 and 28);

b. Its permitted activities:

i. Are significantly limited;

ii. Were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; and

iii. May be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 29 and 30).

c. It shall hold only:

i. Financial assets transferred to it that are passive in nature (paragraph 31);

ii. Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 31 and 32);

iii. Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE;

iv. Servicing rights related to financial assets that it holds;

v. Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 33);

vi. Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:
i. Occurrence of an event or circumstance that:
   (a) Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;
   (b) Is outside the control of the transferor, its affiliates, or its agents; and
   (c) Causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 34 and 35.)

ii. Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder’s beneficial interest back to the SPE (paragraph 36);

iii. Exercise by the transferor of a call specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 42-46);

iv. Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 37).

**Need to Be Demonstrably Distinct from the Transferor**

27. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either:
   a. At least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents; or
   b. The transfer is a guaranteed mortgage securitization.

28. An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

**Limits on Permitted Activities**

29. The powers of the SPE must be limited to those activities allowed by paragraph 26 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

30. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 7 b. are then met by the SPE itself and the conditions in paragraphs 7 a. and 7 c. continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 47).

**Limits on What a Qualifying SPE May Hold**

31. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing.
An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any related entity, such as the transferor, its affiliates, or its agents, is able to exercise control, as defined in SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities (SSAP No. 46), over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments that would allow it and its related entities to control 10% of more of the financial instruments issuer; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE’s assets.

32. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:

a. Is entered into:

   i. When the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents; or

   ii. When a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold.

b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently;

c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

33. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets.

Limits on Sales or Other Dispositions of Assets

34. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that:

a. Is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds;

b. Is outside the control of the transferor, its affiliates, or its agents; and

c. Causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—including requirements to dispose of transferred assets in response to:
i. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee;

ii. A default by the obligor;

iii. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating;

iv. The involuntary insolvency of the transferor; or

v. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

35. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure;

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE;

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

36. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BIH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets;

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put);

c. New beneficial interests in those assets.

37. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.
Investments in Special-Purpose Entities

38. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25.

Agreements That Maintain Effective Control Over Transferred Assets

39. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 40);

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 41);

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

d. The agreement is entered into concurrently with the transfer.

40. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

b. Identical form and type so as to provide the same risks and rights;

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

d. Identical contractual interest rates;

e. Similar assets as collateral; and

f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

41. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

42. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability to cause
the return of specific transferred assets. Such rights preclude sale accounting under paragraph 7. For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause whoever holds that specific asset to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

43. If the transferee is a qualifying SPE, it has met the conditions in paragraph 26 and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor's unilateral ability to cause a qualifying SPE to return to the transferor or otherwise dispose of specific transferred assets at will or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

44. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor’s effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, if an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

45. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

46. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 34 c. i.) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 36 b.), because the transferor could not cause that reacquisition unilaterally.
Changes That Result in the Transferor’s Regaining Control of Assets Sold

47. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor’s regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 7 are no longer met. Such a change, unless it arises solely from either the initial application of this issue paper or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 9). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 30). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor. Subsequent to that date, the reporting entity shall follow statutory accounting for the assets and liabilities in accordance with the guidance in the SSAPs.

Assets Obtained and Liabilities Incurred as Proceeds

48. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

Retained Interests

49. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 48.

50. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

If It Is Not Practicable to Estimate Fair Values

51. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at an allocated cost basis of zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:
a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

b. The amount that would be recognized in accordance with SSAP No. 5.

Securitizations

52. Financial assets such as mortgage loans are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties also have been securitized. Securitizations of nonfinancial assets are outside the scope of this issue paper.

53. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.

54. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

55. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 7 qualify for sale accounting under this issue paper. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 9; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Sales of Future Revenues

56. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.


57. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). If there is a ROAP, the transfer of assets shall not be accounted for as a sale.

Securities Lending Transactions

58. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities shall be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to
the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for
the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the
transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the
collateral. However, if the collateral pledged is available for the general use of the transferor
(unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a
separate liability shall be established on the transferor’s balance sheet to record the obligation to return
the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would
result in nonadmission of the undercollateralized portion. The specific collateral requirements are as
follows:

a. The reporting entity shall receive collateral having a fair value as of the transaction date
at least equal to 102 percent of the fair value of the loaned securities at that date. If at any
time the fair value collateral is less than 100 percent of the fair value of the loaned
securities, the counterparty shall be obligated to deliver additional collateral, the fair
value of which, together with the fair value of all collateral then held in connection with
the transaction at least equals 102 percent of the fair value of the loaned securities;

b. In the event that foreign securities are loaned and the denomination of the currency of the
collateral is other than the denomination of the currency of the loaned foreign securities,
the amount of collateral shall be at least equal to 105 percent of the fair value of the
loaned securities at that date. If at any time the fair value is less than 102 percent of the
fair value of the loaned securities, the reporting entity must obtain additional collateral,
the fair value of which together with the fair value of all collateral then held in
connection with the transaction at least equals 105 percent of the fair value of the loaned
securities.

59. Securities lending transactions are generally initiated by broker-dealers and other financial
institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities
sold. Securities lending transactions typically extend less than one year. Transferees (borrowers) of
securities generally are required to provide collateral to the transferor (lender) of securities, commonly
cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of
the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that
cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the
transferor typically receives a fee. Securities custodians or other agents commonly carry out securities
lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and
adjusted frequently for changes in the market price of the securities transferred) and the short terms of the
transactions, most securities lending transactions in themselves do not impose significant credit risks on
either party. Other risks arise from what the parties to the transaction do with the assets they receive. For
example, investments made with cash collateral impose market and credit risks on the transferor.

60. Many securities lending transactions are accompanied by an agreement that entitles and obligates
the transferor to repurchase or redeem the transferred assets before their maturity under which the
transferor maintains effective control over those assets (paragraphs 39-41). Those transactions shall be
accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract
or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities
loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the
transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral
provided in securities lending transactions that are accounted for as secured borrowings shall be reported
and disclosed like other collateral, as set forth in paragraphs 14 and 58.

61. In some transactions, characterized as securities lending, all of the criteria in paragraph 7 are met,
including the effective control criterion in paragraph 7c., and consideration other than beneficial interests
in the transferred assets is received. During the term of such agreements, the transferor has surrendered
control over the securities transferred and the transferee has obtained control over those securities, with
the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

**Repurchase Agreements and "Wash Sales"**

62. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4 and are admitted assets to the extent they conform to the requirements of this statement.

63. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

64. If the criteria in paragraph 7 are met, including the criterion in paragraph 7 c. i., the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

65. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased within 30 days before or after the sale shall be accounted for as sales under this issue paper. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

66. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 7 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need
not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 40) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

67. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

**Repurchase Agreements**

68. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

69. For repurchase agreements that are accounted for as collateralized lendings in accordance with paragraph 66 of this statement, the underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

70. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

**Reverse Repurchase Agreements**

71. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date. For securities to be substantially the same, the criteria defined in paragraph 40 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

72. For reverse repurchase agreements that are accounted for as collateralized borrowings in accordance with paragraph 66 of this statement, the underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

**Collateral Requirements**

73. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at
anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

74. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 40, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

75. For the seller in a dollar reverse repurchase agreement accounted for as collateralized borrowing in accordance with paragraph 66 of this statement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

76. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 40.

77. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

78. For the purchaser in a dollar repurchase agreement accounted for as collateralized lending in accordance with paragraph 67 of this statement, an asset is recorded for the amount of the purchase. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.
Separate Transactions

79. Agreements to repurchase and resell securities that do not meet the definitions in paragraphs 60 and 66 of this issue paper shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

80. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

81. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

   a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64); or

   b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

82. Otherwise, separate assets and liabilities shall be recognized.

Loan Syndications

83. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

84. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

85. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

86. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

87. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 7 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor’s right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor’s permission that shall not be
unreasonably withheld, or a prohibition on sale to the transferor’s competitor is a limitation on the transferee’s rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

88. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 7 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

89. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42—Sale of Premium Receivables.

Disclosures

90. A reporting entity shall disclose the following:

a. For collateral:
   i. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security;
   ii. If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 14 a., the carrying amount and classification of those assets as of the date of the latest statement of financial position presented;
   iii. If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral; and
   iv. For securities lending transactions, disclose collateral for transactions that extend beyond one year from the reporting date.

b. If debt was considered to be extinguished by in-substance defeasance, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding;

c. If assets are set aside solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets;

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d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;

e. For all servicing assets and servicing liabilities:

i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and

ii. The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans):

i. Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary); and

ii. The characteristics of securitizations (a description of the transferor’s continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations;

iii. The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, if applicable); and

iv. Cash flows between the securitization SPE and the transferor (including proceeds from new securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained.)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans):

i. Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (Glossary);

ii. The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, if applicable);

iii. A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under ii. above independently
from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test; and

iv. For the securitized assets and any other financial assets that the entity manages together with the retained interests:

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period;

(b) Delinquencies at the end of the period; and

(c) Credit losses, net of recoveries, during the period.

v. Disclosure of average balances during the period is encouraged, but not required.

h. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted;

i. A description of the securities underlying repurchase and reverse repurchase agreements, dollar repurchase and dollar reverse repurchase agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

j. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

91. Disclose any transfers of receivables with recourse.

92. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 11, involving transactions for securities with a NAIC designation of 3 or below, or unrated:

a. A description of the reporting entity’s objectives regarding these transactions;

b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;

c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

93. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 92 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

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1 Excluding securitized assets that an entity continues to service but with which it has no other continuing involvement.
Effective Date and Transition

94. Upon adoption of this issue paper, the NAIC will release a Statement of Statutory Accounting Principle (SSAP) for comment. The SSAP will contain the adopted Summary Conclusion of this issue paper. Users of the Accounting Practices and Procedures Manual should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC. It is expected that the SSAP will be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2005, and shall be applied prospectively.

95. For each servicing contract in existence before January 1, 2005, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

DISCUSSION

96. The accounting guidance in this issue paper is consistent with the guidance included in SSAP No. 18, SSAP No. 33 and SSAP No. 45, and is expanded to include issues addressed in FAS 140.

97. This statement adopts FAS 140 with the following modifications:

a. Servicing rights assets are nonadmitted;

b. Sales treatment is not permitted for transactions including recourse provisions or removal-of-accounts provisions on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

c. As statutory financial statements are prepared on a legal entity basis, special purpose entities shall not be consolidated in a reporting entity’s statutory financial statements;

d. Leases shall be accounted for in accordance with SSAP No. 22;

e. Reporting entities required to maintain an IMR shall account for realized and unrealized capital gains and losses in accordance with SSAP No. 7; and

f. The concepts of revolving-period securitizations, banker’s acceptances and risk participations in banker’s acceptances are not applicable for statutory accounting purposes.

98. This issue paper adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor’s Accounting for a Modification or Exchange of Debt Instruments.
99. This issue paper rejects FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, and FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse.

RELEVANT STATUTORY AND GAAP GUIDANCE:

Statutory Accounting

100. SSAP No. 18 provides the following guidance:

SUMMARY CONCLUSION

3. Except as discussed in paragraph 35, a transfer of a group of financial assets, or a portion of a financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if, and only if, all of the following conditions are met:

   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (see paragraphs 12 and 13);

   b. Either (i) each transferee obtains the right, free of conditions that constrain it from taking advantage of that right (see paragraph 14), to pledge or exchange the transferred assets or (ii) the transferee is a qualifying special-purpose entity as defined in paragraph 9 of SSAP No. 33 and the holders of beneficial interests in that entity have the right, free of conditions that constrain them from taking advantage of that right (see paragraph 14), to pledge or exchange those interests; and

   c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 15-17) or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (see paragraph 18).

4. Upon completion of any transfer of financial assets, the transferor shall:

   a. Continue to carry in its balance sheet any retained interest in the transferred assets, including, if applicable, beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (see SSAP No. 33), and retained undivided interests (see paragraph 20); and

   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (see paragraphs 19 and 20).

5. Upon completion of a transfer of assets that satisfies the conditions to be accounted for as a sale (see paragraph 3), the transferor (seller) shall:

   a. Eliminate the transferred assets from the balance sheet;

   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
c. Record in its balance sheet, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);

d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 5 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses in the statement of income.

6. The transferee shall recognize all assets obtained and any liabilities incurred, and initially measure them at fair value (in aggregate, presumptively the price paid).

7. Repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements shall meet the definition of SSAP No. 45. When an asset is sold and the proceeds are reinvested within 30 days in the same or substantially the same security, such transfers shall be considered to be wash sales and shall be accounted for as sales and disclosed as required by paragraph 37. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

8. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) (a) does not meet the criteria for a sale in paragraph 3, or (b) is a sale of receivables with recourse (see paragraph 35); the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (see paragraph 10).

Recognition and Measurement of Servicing Assets and Liabilities

9. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained, or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value.

Secured Borrowings and Collateral

10. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (see paragraph 8). The accounting for
collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral, and on the rights and obligations that result from the collateral arrangement:

a. If the secured party is permitted to sell or repledge the collateral, and the debtor does not have the right and ability to redeem the collateral on short notice, (e.g., by substituting other collateral or terminating the contract), then:

i. The debtor shall disclose the amount of such assets and the secured party’s right to sell or repledge such collateral;

ii. The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.

b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or repledging of the asset is a transfer subject to the provisions of this statement;

c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral. The secured party shall recognize the collateral as an asset (to the extent it has not already recognized it) and initially measure it at fair value;

d. Otherwise, the debtor shall continue to carry the collateral as an asset, and the secured party shall not recognize the pledged asset.

Extinguishments of Liabilities

11. A debtor shall derecognize a liability if, and only if, it has been extinguished (see SSAP No. 15). A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities; or

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Isolation Beyond the Reach of the Transferor and Its Creditors

12. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (see SSAP No. 33).
13. Many common financial transactions, for example, typical repurchase agreements (see SSAP No. 45) and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

**Conditions That Constrain a Transferee**

14. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

**Agreements That Maintain Effective Control Over Transferred Assets**

15. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

   a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (see paragraph 16);

   b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (see paragraph 17);

   c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price; and

   d. The agreement is entered into concurrently with the transfer.

16. To be substantially the same, the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

   a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same);

   b. Identical form and type so as to provide the same risks and rights;

   c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield);

   d. Identical contractual interest rates;

   e. Similar assets as collateral; and

   f. The same aggregate unpaid principal amount or principal amounts within accepted good delivery standards for the type of security involved.

17. To be able to repurchase or redeem assets on substantially all of the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.
18. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor’s effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

**Assets Obtained and Liabilities Incurred as Proceeds**

19. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value.

**Retained Interests**

20. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. That procedure shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 19.

**Fair Value**

21. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a quoted market price is available, the fair value is the product of the number of trading units times market price.

22. If quoted market prices are not available, the estimate of fair value shall be based on the best information available. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value by discounting estimated future cash flows, an objective is to use discount rates at which those liabilities could be settled in an arm's-length transaction.

23. Estimates of expected future cash flows, if used to estimate fair value, shall be the best estimate based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered in determining the best estimate of future cash flows.
If It Is Not Practicable to Estimate Fair Values

24. If it is not practicable to estimate the fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

   a. The excess, if any, of (i) the fair values of assets obtained less the fair values of other liabilities incurred, over (ii) the sum of the carrying values of the assets transferred;

   b. The amount that would be recognized in accordance with SSAP No. 5—Liabilities, Contingencies and Impairments of Assets.

Securities Lending Transactions

25. When securities are loaned, they remain assets of the reporting entity and are not removed from the accounting records. Any fees received by the transferor for loaning the securities should be recorded as miscellaneous income. During a securities lending transaction, collateral is pledged by the transferee to the transferor that has loaned the securities. If the collateral pledged by the transferee is not available for the general use of the transferor (restricted), then the transferor shall not reflect the collateral in the transferor’s balance sheet as an asset, and the transferor shall not establish a liability for the return of the collateral. However, if the collateral pledged is available for the general use of the transferor (unrestricted), then the collateral shall be recorded as an asset on the transferor’s balance sheet and a separate liability shall be established on the transferor’s balance sheet to record the obligation to return the collateral. The failure by the transferor to maintain sufficient collateral for the loaned securities would result in nonadmission of the undercollateralized portion. The specific collateral requirements are as follows:

   a. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 102 percent of the fair value of the loaned securities at that date. If at any time the fair value collateral is less than 100 percent of the fair value of the loaned securities, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction at least equals 102 percent of the fair value of the loaned securities.

   b. In the event that foreign securities are loaned and the denomination of the currency of the collateral is other than the denomination of the currency of the loaned foreign securities, the amount of collateral shall be at least equal to 105 percent of the fair value of the loaned securities at that date. If at any time the fair value is less than 102 percent of the fair value of the loaned securities, the reporting entity must obtain additional collateral, the fair value of which together with the fair value of all collateral then held in connection with the transaction at least equals 105 percent of the fair value of the loaned securities.

26. Securities lending transactions are generally initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Transferees (borrowers) of securities generally are required to provide collateral to the transferor (lender) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do...
with the assets they receive. For example, investments made with cash collateral impose market and credit risks on the transferor.

27. Securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (see paragraphs 15-18). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported and disclosed like other collateral, as set forth in paragraphs 10 and 25.

28. In some transactions, characterized as securities lending, all of the criteria in paragraph 3 are met. During the term of such agreements, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities, with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment. Those transactions shall be accounted for:

   a. By the transferor as a sale of the loaned securities, for proceeds consisting of the collateral and a forward repurchase commitment. (If the collateral is a financial asset that the holder is permitted to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, e.g., by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the loaned securities. To the extent that the collateral consists of letters of credit or other financial instruments that the holder is not permitted to sell or pledge, a securities lending transaction does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee); and

   b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

Loan Syndications

29. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

30. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender who then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is also functioning as a servicer and, therefore, shall only recognize its portion of the loan as an asset.

Loan Participations

31. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

32. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor (originating lender) continues to service the loan. The transferee (participating entity) may or may not have the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.
33. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 3 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor has not relinquished control over the loan and shall account for the transfers as secured borrowings.

Factoring Arrangements

34. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 3 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

35. In a transfer of receivables with recourse, the transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. A transfer of receivables with recourse shall not be recognized as a sale but rather, as a financing. A transfer of receivables without recourse shall only be recognized if the transferor receives cash for the receivables. The sale shall be recognized when cash is received. Sales of premium receivables are addressed in SSAP No. 42.

Disclosures

36. A reporting entity shall disclose the following:
   a. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value;
   b. Description of any loaned securities, including the amount, a description of, and the policy for, requiring collateral, and whether or not the collateral is restricted; and
   c. For all servicing assets and servicing liabilities:
      i. The amounts of servicing assets nonadmitted or liabilities recognized and amortized during the period; and
      ii. The fair value of servicing liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value.

37. A reporting entity shall disclose the following information for wash sales, as defined in paragraph 7, involving transactions for securities with a NAIC designation of 3 or below, or unrated:
   a. A description of the reporting entity’s objectives regarding these transactions;
   b. An aggregation of transactions by NAIC Designation 3 or below, or unrated;
c. The number of transactions involved during the reporting period;

d. The book value of securities sold;

e. The cost of securities repurchased; and

f. The realized gains/losses associated with the securities involved.

38. Refer to the preamble for further discussion regarding disclosure requirements. The disclosures required by paragraph 37 shall be made for the current quarter in the quarterly statement and for the year in the annual statement.

Relevant Literature

39. This statement adopts FAS 125 with modification to paragraphs 9, 10 a., 11 d., 13, 15—17, 35—41, and 68. Additionally, paragraphs 14, 59—60, 77—81, and 83 are rejected. The modifications to FAS 125 primarily relate to (a) the nonadmission of servicing rights assets, (b) the accounting for repurchase agreements, reverse repurchase agreements, and dollar repurchase agreements, (c) the accounting for realized gains and losses for reporting entities required to maintain an IMR, (d) the accounting for financial assets subject to prepayment, (e) the accounting for assets pledged as collateral, (f) the accounting for leases in accordance with SSAP No. 22—Leases, and (g) the accounting for sales of receivables with recourse. Paragraphs 77-81 are rejected because they are not applicable to the insurance industry.

40. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as used in Certain Audit Guides and a Statement of Position. This statement adopts FASB Emerging Issues Task Force No. 87-34, Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 88-11, Allocation of Recorded Investment When a Loan as Part of a Loan is Sold, FASB Emerging Issues Task Force No. 88-18, Sales of Future Revenues, FASB Emerging Issues Task Force No. 88-22, Securitization of Credit Card and Other Receivable Portfolios, FASB Emerging Issues Task Force No. 90-21, Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement, FASB Emerging Issues Task Force No. 95-5, Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights and FASB Emerging Issues Task Force No. 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments.

41. This statement rejects FASB Statement No. 127, Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125, an amendment of FASB Statement No. 125, FASB Emerging Issues Task Force No. 84-5, Sale of Marketable Securities with a Put Option, FASB Emerging Issues Task Force No. 92-2, Measuring Loss Accruals by Transferors of Receivables with Recourse, and FASB Emerging Issues Task Force No. 96-20, Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities.

Effective Date and Transition

42. This statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after January 1, 2001, and shall be applied prospectively.

43. For each servicing contract in existence before January 1, 2001, previously recognized or nonadmitted servicing rights and excess servicing receivables shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset (nonadmitted) or liability. Thereafter, the subsequent measurement provisions of this statement shall be applied to the servicing assets (nonadmitted) or liabilities for those servicing contracts.

101. SSAP No. 33 provides the following guidance:

Accounting for Securitizations of Financial Assets
3. A financial asset shall be defined as cash, evidence of an ownership interest in an entity, or a contract that both
   a. Imposes on one entity a contractual obligation (i) to deliver cash or another financial instrument to a second entity or (ii) to exchange other financial instruments on potentially unfavorable terms with the second entity; and
   b. Conveys to that second entity a contractual right (i) to receive cash or another financial instrument from the first entity or (ii) to exchange other financial instruments on potentially favorable terms with the first entity.

4. A securitization in which the transferor surrenders control over the financial asset transferred shall be accounted for as a sale, with recognition of proceeds and measurement of a gain or loss only to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The portion of the securitization for which beneficial interests in the transferred assets are received shall not be accounted for as a sale, but shall be treated as an exchange of assets with no measurement of a gain or loss. All other securitizations shall be accounted for as secured borrowings in accordance with paragraph 11.

5. The transferor has surrendered control if, and only if, all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership;
   b. The transferee is a qualifying special-purpose entity and the holders of beneficial interests in that entity have the right—free of transferor-imposed conditions that constrain them from taking advantage of that right—to pledge or exchange those interests; and
   c. The transferor does not maintain effective control over the transferred assets through (i) an agreement that entitles and obligates the transferor to repurchase or redeem them before their maturity, or (ii) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable.

6. A beneficial interest shall be defined as the right to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest or principal inflows to be “passed through” or “paid through,” premiums due guarantors, and residual interests. Residual interests are interests in the cash flows of the trust or other entity, after the cash flows of structured securities issued by the trust are met.

7. Upon completion of the securitization of financial assets meeting the criteria for sales treatment required by paragraph 5, the transferor shall:
   a. Eliminate the transferred assets from the statement of financial position;
   b. Allocate the previous carrying amount of the transferred assets to the securities representing beneficial interests retained by the reporting entity, if any, and the securities representing beneficial interests not retained, if any, based on the relative fair values of the transferred assets at the date of transfer;
   c. Record in its statement of financial position, the allocated carrying value of the securities representing retained beneficial interests in the assets (e.g., loan-backed securities);
d. Recognize all additional assets obtained (i.e., other than the securities representing retained beneficial interests which are recorded in accordance with 7 c.) and liabilities incurred in consideration as proceeds of the sale;

e. Initially measure such additional assets obtained and liabilities incurred in the sale at fair value; and

f. For reporting entities required to maintain an Interest Maintenance Reserve (IMR), the accounting for realized capital gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve. For reporting entities not required to maintain an IMR, realized gains and losses shall be reported as net realized capital gains or losses line in the Investment Income section of the Underwriting and Investment Exhibit.

8. The successor (transferee) shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value.

9. A qualifying special-purpose entity (including a CMO special-purpose entity) as used in this statement must meet all of the following conditions:

   a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:

      i. Holding title to transferred financial assets;

      ii. Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.);

      iii. Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held; and

      iv. Distributing proceeds to the holders of its beneficial interests.

   b. It has a standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust, and thereby resume control over the individual assets held in the trust, and the transferor can effectively assign its interest and its creditors can reach it. In that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualified special-purpose entity. A special-purpose entity that has distinct standing at law may still be an affiliate of the transferor.

**Investments in Special-Purpose Entities**

10. Reporting entities that have qualifying special-purpose entities as affiliates shall carry their investment in such entity at its underlying statutory book value in accordance with SSAP No. 46—Investments in Subsidiary, Controlled, and Affiliated Entities. Additionally, transactions entered involving affiliated qualifying special-purpose entities are subject to the provisions of SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties.

**Secured Obligations and Collateral**

11. Securitizations of financial assets that do not meet the criteria for sale treatment set forth in paragraph 5 shall be presumed to be secured borrowings and shall be recorded as follows. Financial assets shall remain on the reporting entity’s books and a liability shall be recorded to
reflect the proceeds from the issuance of any type of certificate. Non-cash proceeds shall be recorded as a contra liability and netted against the liability. The liability shall be reduced as the obligation to holders of beneficial interests is repaid. Financial assets pledged as collateral shall not be offset against the liability reflecting the proceeds of the transaction.

Recognition of Servicing Rights

12. Servicing rights become a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing. If distinct servicing rights to transferred assets exist and are retained by the reporting entity, the reporting entity shall recognize a servicing asset or liability. When the servicing fees to be received exceed the cost of servicing the transferred assets, a servicing asset is recognized and nonadmitted. When the cost of servicing the transferred assets is greater than the servicing fees to be received, a liability shall be recorded for the excess to recognize this obligation. A corresponding loss shall be recorded through the Summary of Operations. The servicing asset or liability shall be amortized into income in proportion to, and over the period of estimated servicing income (if an asset) or estimated servicing loss (if a liability). The servicing asset or liability shall be measured in a manner consistent with paragraphs 13 and 35 through 38 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125).

Sales of Future Revenues

13. In addition to securitization of assets, some reporting entities have entered into transactions characterized as a sale of future revenues. These transactions are sometimes referred to as securitizations and are sometimes characterized as selling deferred acquisition costs. A sale of future revenues by a reporting entity shall not result in the immediate recognition of income or surplus. The proceeds of any such sale shall be established as a liability and shall be reduced as the proceeds are repaid.

Relevant Literature

14. This statement adopts portions of FAS 125, with the following modifications (FAS 125 is addressed in its entirety in SSAP No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities):

   a. This statement requires servicing rights assets to be nonadmitted;
   b. This statement does not permit sales treatment for transactions where recourse provisions exist or where "call" or "put" options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;
   c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FAS 125 requires the encumbered assets to be reported separately from unencumbered assets;
   d. This statement does not address transfers of financial assets accomplished in a manner other than through securitizations whereas FAS 125 does address such transfers; and
   e. Paragraph 14 is rejected as it is not applicable.

Effective Date and Transition

15. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.
SSAP No. 45 provides the following guidance:

2. Repurchase agreements, reverse repurchase agreements and dollar repurchase agreements meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement.

Repurchase Agreements

3. Repurchase agreements are defined as agreements under which a reporting entity purchases securities and simultaneously agrees to resell the same or substantially the same securities at a stated price on a specified date within 12 months of the purchase. For securities to be substantially the same, the criteria defined in paragraph 14 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

4. Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity. The amount paid for the securities shall be reported as a short-term investment, and the difference between the amount paid and the amount at which the securities will be subsequently resold shall be reported as interest income, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement.

5. Reporting entities generally take possession of the underlying collateral under repurchase agreements and in many cases may obtain additional collateral when the estimated fair value of such securities falls below their current contract value. However, to the extent that the current fair value of the collateral is less than the recorded amount, the shortfall shall reduce the admitted asset value of the repurchase agreement.

Reverse Repurchase Agreements

6. Reverse repurchase agreements are defined as agreements under which a reporting entity sells securities and simultaneously agrees to repurchase the same or substantially the same securities at a stated price on a specified date within 12 months of the sale date. For securities to be substantially the same, the criteria defined in paragraph 13 must be met, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

7. Reverse repurchase agreements shall be accounted for as collateralized borrowings (financing transactions). The underlying securities shall continue to be accounted for as an investment by the reporting entity. The proceeds from the sale of the securities shall be recorded as a liability, and the difference between the proceeds and the amount at which the securities will be subsequently reacquired shall be reported as interest expense, calculated on the straight-line method or the scientific interest (constant yield) method, over the term of the agreement. Although recording these transactions gross tends to inflate assets and liabilities, it more closely reflects the financing nature of the transactions and their associated leverage impact to the financial statements.

Collateral Requirements

8. The collateral requirements for repurchase and reverse repurchase agreements are as follows:

   Repurchase Transaction

   a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty...
shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price.

Reverse Repurchase Transaction

b. The reporting entity shall receive collateral having a fair value as of the transaction date at least equal to 95 percent of the fair value of the securities transferred by the reporting entity in the transaction as of that date. If at anytime the fair value of the collateral is less than 95 percent of the fair value of the securities so transferred, the counterparty shall be obligated to deliver additional collateral, the fair value of which, together with the fair value of all collateral then held in connection with the transaction, at least equals 95 percent of the fair value of the transferred securities.

Dollar Repurchase Agreements

9. Dollar repurchase and dollar reverse repurchase agreements are defined as repurchase and reverse repurchase agreements involving debt instruments that are pay-through securities collateralized with Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) collateral, and pass-through certificates sponsored by GNMA, mortgage participation certificates issued by the FHLMC or similar securities issued by the FNMA. Dollar repurchase agreements are also commonly referred to as dollar roll transactions. To meet the definition of dollar repurchase and dollar reverse repurchase agreements, the securities underlying the agreements must meet the criteria defined in paragraph 13, and for mortgage-backed securities excluding mortgage pass-through securities, the projected cash flows of the securities must be substantially the same under multiple scenario prepayment assumptions.

10. For the seller in a dollar reverse repurchase agreement, a liability is recorded for the amount of proceeds of the sale and the sold mortgage-backed securities are not removed from the accounting records. During the period of the agreement, interest income is recorded as if the mortgage-backed security had been held during the term of the agreement. This is offset by an equal amount of interest expense related to the proceeds received from the sale. Additional interest expense is recorded representing the difference between the sales price and the repurchase price of the mortgage-backed securities sold.

11. When the mortgage-backed securities are repurchased under the agreement, the original mortgage-backed securities sold are removed from the accounting records and the purchased mortgage-backed securities are recorded. The principal amount of the mortgage-backed securities repurchased must be in good delivery form consistent with paragraph 13.

12. If the principal amount repurchased is greater than the amount sold, the cash paid is recorded as an additional investment in the newly acquired certificates. If the principal amount repurchased is less than the amount sold, a gain or loss relating to the original certificates held is recorded.

13. For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of the purchase. Since the term of the agreement is limited to twelve months, it is accounted for as a short-term investment. Upon completion of the reverse repurchase agreement, cash is received in exchange for a “substantially the same” security. The difference between the purchase and reselling price represents interest income for the lending of short-term funds.

Criteria to Meet Substantially the Same

14. For debt instruments, including mortgage-backed securities, to be substantially the same, all the following criteria must be met:
a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same;

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder;

c. The debt instruments must bear the identical contractual interest rate;

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield;

e. Mortgage-backed pass-through and pay through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages; and

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted “good delivery” standard for the type of mortgage-backed security involved.

Separate Transactions

15. Agreements to repurchase and resell securities that do not meet the definitions in paragraph 3, 6, or 8 of this statement shall be accounted for as two separate transactions, that is, as a sale and purchase or as a purchase and sale, in accordance with the relevant statutory accounting guidance. For example, sales of bonds would result in recognition of realized gains or losses.

Offsetting

16. Reporting entities may operate on both sides of the repurchase agreement market resulting in recording of liabilities and assets representing repurchase and reverse repurchase agreements, respectively.

17. Reporting entities shall offset such liabilities and assets only to the extent that one of the following occurs:

a. A legal right of offset exists as defined in SSAP No. 64—Offsetting and Netting of Assets and Liabilities (SSAP No. 64), or

b. The securities have the same settlement date, are executed with the same counterparty in accordance with a master netting arrangement, involve securities that exist in “book entry” form, and settle on securities transfer systems that have the same key elements and operating characteristics as the Fedwire Securities Transfer System.

Otherwise, separate assets and liabilities shall be recognized.

Disclosures

18. The following disclosures shall be made in the financial statements:

a. If the reporting entity has entered into repurchase agreements, its policy for requiring collateral or other security;
b. A description of the securities underlying the agreements, including book values and fair values, maturities, and weighted average interest rates for the following categories: (i) securities subject to reverse repurchase agreements; (ii) securities subject to repurchase agreements; (iii) securities subject to dollar repurchase agreements; and (iv) securities subject to dollar reverse repurchase agreements; and

c. A description of the terms of reverse repurchase agreements whose amounts are included in borrowed money.

19. Refer to the preamble for further discussion regarding disclosure requirements.

Relevant Literature

20. This statement adopts AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used In Certain Audit Guides and a Statement of Position.

21. This statement adopts paragraphs 9 through 13, 15 through 17, 23 through 25, 27 through 30 and 66 through 71 of FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125), as they relate to repurchase agreements, reverse repurchase agreements and dollar repurchase agreements.

22. This statement adopts FASB Emerging Issues Task Force No. 84-20, GNMA Dollar Rolls. This statement is consistent with FASB Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105 (FIN 39) (as it relates to reverse repurchase and repurchase agreements) and FASB Interpretation No. 41, Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39 (FIN 41). FIN 39 and FIN 41 are adopted in SSAP No. 64.

23. This statement rejects paragraph 14 of FAS 125 as it relates to the classifications of securities under FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities (FAS 115). FAS 115 is rejected in SSAP No. 26—Bonds, excluding Loan-backed and Structured Securities.

Effective Date and Transition

24. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors.

103. INT 01-31: Assets Pledged as Collateral (INT 01-31) provides the following guidance:

INT 01-31 Issue

1. Insurers may enter into certain transactions that require the granting of a security interest in certain assets to another party to serve as collateral for their performance under a contract. The arrangement is commonly referred to as a pledge, typically accomplished by delivery of assets to the secured party or to an independent custodian. In these transactions, the pledging insurer typically (1) continues to receive the income on the pledged collateral and (2) can remove and substitute other securities with little or no advance notice to the secured party as long as they comply with related investment quality and market value agreement provisions. Examples include collateral pledged under investment, derivative, debt obligations and policyholder transactions.

2. Specific examples of collateral pledged for derivative and investment transactions include but are not limited to: (1) securities posted with a broker as margin for futures and options transactions, (2) securities pledged to secure credit exposure with swap counterparties, (3)
securities pledged under reverse repurchase agreements or securitizations that are accounted for as secured borrowing transactions and (4) securities pledged under securities lending transactions.

3. Specific examples of collateral pledged for debt obligations and policyholder transactions include but are not limited to assets pledged to secure (1) debt borrowings from or insurance contracts issued to banking entities and (2) insurance contracts issued to governmental entities such as municipalities.

4. Under these transactions, the fair value of the securities pledged as collateral may exceed the contract balance (swap fair value, advance balance, policyholder account balance, etc.). For this interpretation, this excess carrying value of securities pledged over the corresponding asset or contract balance is called the “overcollateralization” amount.

5. The accounting issue is whether the assets pledged as collateral under the various transactions mentioned above should be considered admitted assets.

INT 01-31 Discussion

6. The working group reached a consensus that if the collateral had not been pledged in the examples described above, it is assumed the underlying asset would be recorded as an admitted asset under SSAP No. 4 (e.g. they are readily marketable assets available to meet both current and future policyholder obligations). In addition, it is assumed that the asset would not be considered impaired under SSAP No. 5 due to a default, market value decline, or other loss contingency.

7. Therefore, for the examples described above, the pledging insurer would record the collateral (including the overcollateralization amount) as an admitted asset until they have committed a contract default that has not been cured in accordance with the contract provisions. This accounting is in accordance with the provisions of SSAP Nos. 18, 33 and 45. This consensus of reporting collateral as an admitted asset is further supported by SSAP Nos. 4 and 5 since generally, the insurer can readily substitute pledged assets. Additionally, an insurer may typically unwind the transaction allowing the assets to be available to the pledging insurer to meet policyholder obligations. Furthermore, no event has occurred to indicate an impairment or potential loss contingency with respect to such pledged assets. The fact that some pledged assets may constitute an overcollateralization amount does not change this analysis. Accordingly, all assets pledged in support of these type transactions should also be admitted.

8. At the time of an uncured default, the provisions of paragraph 10 of SSAP No. 18 shall be used to determine the appropriate accounting treatment for the collateral. If the secured party utilizes collateral to offset all or a portion of the liability owed by the pledging insurer as a result of the default, then the collateral amount utilized to offset the liability shall be removed from the balance sheet. At the same time, the amount of the liability that was offset should be removed from the balance sheet since that obligation has been satisfied through the secured party’s utilization of that collateral. To the extent that an uncured default remains without the secured party utilizing the collateral to offset the obligation, the pledging insurer should only record an admitted asset for the amount of collateral that it can redeem.

INT 01-31 Status

9. The consensus position of this interpretation is consistent with the position of the NAIC Invested Asset (E) working group. This interpretation will be reviewed by the FAS 140 Subgroup of the NAIC Statutory Accounting Principles (E) working group in conjunction of its consideration of incorporating GAAP pronouncement FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125 into the statutory accounting model. As such, this interpretation is subject to amendment pending disposition of the FAS 140 Subgroup’s review of collateral and FAS 140 in its entirety.
Generally Accepted Accounting Principles

104. FAS 140 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
   a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).
   b. Each transferee (or, if the transferee is a qualifying SPE (paragraph 35), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29-34).
   c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47-49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50-54).

10. Upon completion of any transfer of financial assets, the transferor shall:
   a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 61-67), beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73-84), and retained undivided interests (paragraphs 58 and 59)
   b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 56-60).

11. Upon completion 3 of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
   a. Derecognize all assets sold
   b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 56, 57, and 61-67)
   c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 68-70) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 71 and 72)
   d. Recognize in earnings any gain or loss on the sale.

The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

Recognition and Measurement of Servicing Assets and Liabilities
13. Each time an entity undertakes an obligation to service financial assets it shall recognize either a servicing asset or a servicing liability for that servicing contract, unless it transfers the assets to a qualifying SPE in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. If the servicing asset or liability was purchased or assumed rather than undertaken in a sale or securitization of the financial assets being serviced, it shall be measured initially at its fair value, presumptively the price paid. A servicing asset or liability shall be amortized in proportion to and over the period of estimated net servicing income (if servicing revenues exceed servicing costs) or net servicing loss (if servicing costs exceed servicing revenues). A servicing asset or liability shall be assessed for impairment or increased obligation based on its fair value (paragraphs 61-64).

Financial Assets Subject to Prepayment

14. Interest-only strips, retained interests in securitizations, loans, other receivables, or other financial assets that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment, except for instruments that are within the scope of Statement 133, shall be subsequently measured like investments in debt securities classified as available-for-sale or trading under Statement 115, as amended (paragraph 362).

Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

a. If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) shall reclassify that asset and report that asset in its statement of financial position separately (for example, as security pledged to creditors) from other assets not so encumbered.

b. If the secured party (transferee) sells collateral pledged to it, it shall recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to the provisions of this Statement.

c. If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it shall derecognize the pledged asset, and the secured party (transferee) shall recognize the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

d. Except as provided in paragraph 15(c), the debtor (transferor) shall continue to carry the collateral as its asset, and the secured party (transferee) shall not recognize the pledged asset.

Extinguishments of Liabilities

16. A debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or
reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.

Disclosures

17. An entity shall disclose the following:
   a. For collateral:
      (1) If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
      (2) If the entity has pledged any of its assets as collateral that are not reclassified and separately reported in the statement of financial position pursuant to paragraph 15(a), the carrying amount and classification of those assets as of the date of the latest statement of financial position presented
      (3) If the entity has accepted collateral that it is permitted by contract or custom to sell or repledge, the fair value as of the date of each statement of financial position presented of that collateral and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral
   b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of Statement 125, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
   c. If assets are set aside after the effective date of Statement 125 solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
   d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
   e. For all servicing assets and servicing liabilities:
      (1) The amounts of servicing assets or liabilities recognized and amortized during the period
      (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
      (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 63
      (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.
   f. If the entity has securitized financial assets during any period presented and accounts for that transfer as a sale, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):
      (1) Its accounting policies for initially measuring the retained interests, if any, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)
      (2) The characteristics of securitizations (a description of the transferor’s continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests) and the gain or loss from sale of financial assets in securitizations
      (3) The key assumptions used in measuring the fair value of retained interests at the time of securitization (including, at a minimum, quantitative information about
discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, 8 and anticipated credit losses, if applicable) 

(4) Cash flows between the securitization SPE and the transferor, unless reported separately elsewhere in the financial statements or notes (including proceeds from new securitizations, proceeds from collections reinvested in revolving-period securitizations, purchases of delinquent or foreclosed loans, servicing fees, and cash flows received on interests retained)

g. If the entity has retained interests in securitized financial assets at the date of the latest statement of financial position presented, for each major asset type (for example, mortgage loans, credit card receivables, and automobile loans):

(1) Its accounting policies for subsequently measuring those retained interests, including the methodology (whether quoted market price, prices based on sales of similar assets and liabilities, or prices based on valuation techniques) used in determining their fair value (paragraphs 68-70)

(2) The key assumptions used in subsequently measuring the fair value of those interests (including, at a minimum, quantitative information about discount rates, expected prepayments including the expected weighted-average life of prepayable financial assets, and anticipated credit losses, including expected static pool losses, 9 if applicable)

(3) A sensitivity analysis or stress test showing the hypothetical effect on the fair value of those interests of two or more unfavorable variations from the expected levels for each key assumption that is reported under (2) above independently from any change in another key assumption, and a description of the objectives, methodology, and limitations of the sensitivity analysis or stress test

(4) For the securitized assets and any other financial assets that it manages together with them: 10

(a) The total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period

(b) Delinquencies at the end of the period

(c) Credit losses, net of recoveries, during the period

Disclosure of average balances during the period is encouraged, but not required.

Implementation Guidance

18. Appendix A describes certain provisions of this Statement in more detail and describes their application to certain types of transactions. Appendix A is an integral part of the standards provided in this Statement.

Effective Date and Transition

19. Except as provided in paragraphs 20–25, this Statement shall be effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. This Statement shall be applied prospectively, 11 except as provided in paragraphs 20, 21, 23, and 24. Earlier or retroactive application of this Statement is not permitted.

20. For each servicing contract in existence before January 1, 1997, previously recognized servicing rights and "excess servicing" receivables that do not exceed contractually specified servicing fees shall be combined, net of any previously recognized servicing obligations under that contract, as a servicing asset or liability. Previously recognized servicing receivables that exceed contractually specified servicing fees shall be reclassified as interest-only strips receivable. Thereafter, the subsequent measurement provisions of this Statement shall be applied to the servicing assets or liabilities for those servicing contracts (paragraph 63) and to the interest-only strips receivable (paragraph 14).

21. The provisions of paragraph 14 and the amendment to Statement 115 (paragraph 362) shall be effective for financial assets held on or acquired after January 1, 1997.
22. Paragraphs 17(f) and 17(g) shall be effective for financial statements for fiscal years ending after December 15, 2000. The information required to be disclosed about securitizations of financial assets during the period that are accounted for as sales need not be reported for periods ending on or before December 15, 2000, for which an income statement is presented for comparative purposes.

23. Collateral previously recognized in financial statements in accordance with the requirements of paragraphs 15(a)(ii) and 15(b) of Statement 125 that is no longer to be recognized in accordance with paragraph 15 of this Statement shall no longer be recognized in financial statements for fiscal years ending after December 15, 2000, and financial statements for previous periods presented for comparative purposes shall be restated accordingly. The requirements for reclassification of certain assets in paragraph 15(a) of this Statement and for disclosure about collateral pledged and accepted in paragraphs 17(a)(2) and 17(a)(3) shall be effective for financial statements for fiscal years ending after December 15, 2000; that information need not be reported for periods ending on or before December 15, 2000, for which a statement of financial position is presented for comparative purposes.

24. Assets transferred on or before March 31, 2001, and transfers of assets after that date required by commitments made before that date to transferees or beneficial interest holders (BIHs) other than the transferor, its affiliates, 12 or its agents shall continue to be accounted for under the previous accounting standards for transfers of assets that applied when the transferor made or committed to those transfers. Transfers of assets after that date, unless required by commitments made before that date to transferees or BIHs unrelated to the transferor, shall be subject to all the provisions of this Statement.

25. A formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE under this Statement shall continue to be considered a qualifying SPE if it maintains its qualifying status under previous accounting standards, does not issue new beneficial interests after the effective date, and does not receive assets it was not committed to receive (through a commitment to BIHs unrelated to the transferor) before the effective date. Otherwise, the formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance and to all the provisions of this Statement.

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

26. This appendix describes certain provisions of this Statement in more detail and describes how they apply to certain types of transactions. This appendix discusses generalized situations. Facts and circumstances and specific contracts need to be considered carefully in applying this Statement. This appendix is an integral part of the standards provided in this Statement.

Isolation beyond the Reach of the Transferor and Its Creditors

27. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any
consolidated affiliate of the transferor that is not a special-purpose corporation or other entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 83(c)).

28. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 80-84). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

Conditions That Constrain a Transferee

29. Sale accounting is allowed under paragraph 9(b) only if each transferee has the right to pledge, or the right to exchange, the transferred assets or beneficial interests it received, but constraints on that right also matter. Many transferor-imposed or other conditions on a transferee's right to pledge or exchange a transferred asset both constrain a transferee from pledging or exchanging the transferred assets and, through that constraint, provide more than a trivial benefit to the transferor. For example, a provision in the transfer contract that prohibits selling or pledging a transferred loan receivable not only constrains the transferee but also provides the transferor with the more-than-trivial benefits of knowing who has the asset, a prerequisite to repurchasing the asset, and of being able to block the asset from finding its way into the hands of a competitor for the loan customer's business or someone that the loan customer might consider an undesirable creditor. Transferor-imposed contractual constraints that narrowly limit timing or terms, for example, allowing a transferee to pledge only on the day assets are obtained or only on terms agreed with the transferor, also constrain the transferee and presumptively provide the transferor with more-than-trivial benefits.

30. However, some conditions do not constrain a transferee from pledging or exchanging the asset and therefore do not preclude a transfer subject to such a condition from being accounted for as a sale. For example, a transferor's right of first refusal on the occurrence of a bona fide offer to the transferee from a third party presumptively would not constrain a transferee, because that right in itself does not enable the transferor to compel the transferee to sell the assets and the transferee would be in a position to receive the sum offered by exchanging the asset, albeit possibly from the transferor rather than the third party. Further examples of conditions that presumptively would not constrain a transferee include (a) a requirement to obtain the transferor's permission to sell or pledge that is not to be unreasonably withheld, (b) a prohibition on sale to the transferor's competitor if other potential willing buyers exist, (c) a regulatory limitation such as on the number or nature of eligible transferees (as in the case of securities issued under Securities Act Rule 144A or debt placed privately), and (d) illiquidity, for example, the absence of an active market. Judgment is required to assess the significance of some conditions. For example, a prohibition on sale to the transferor's competitor would be a significant constraint if that competitor were the only potential willing buyer other than the transferor.

31. A condition imposed by a transferor that constrains the transferee presumptively provides more than a trivial benefit to the transferor. A condition not imposed by the transferor that constrains the transferee may or may not provide more than a trivial benefit to the transferor. For example, if the transferor refrains from imposing its usual contractual constraint on a specific transfer because it knows an equivalent constraint is already imposed on the transferee by a third party, it presumptively benefits more than trivially from that constraint. However, the transferor cannot benefit from a constraint if it is unaware at the time of the transfer that the transferee is constrained.
Transferor’s Rights or Obligations to Reacquire Transferred Assets

32. Some rights or obligations to reacquire transferred assets both constrain the transferee and provide more than a trivial benefit to the transferor, thus precluding sale accounting under paragraph 9(b). For example, a freestanding call option written by a transferee to the transferor benefits the transferor and, if the transferred assets are not readily obtainable in the marketplace, is likely to constrain a transferee because it might have to default if the call was exercised and it had exchanged or pledged the assets. A freestanding forward purchase-sale contract between the transferor and the transferee on transferred assets not readily obtainable in the marketplace would benefit the transferor and is likely to constrain a transferee in much the same manner. Judgment is necessary to assess constraint and benefit. For example, put options written to the transferee generally do not constrain it, but a put option on a not-readily-obtainable asset may benefit the transferor and effectively constrain the transferee if the option is sufficiently deep-in-the-money when it is written that it is probable that the transferee will exercise it and the transferor will reacquire the transferred asset. In contrast, a sufficiently out-of-the-money call option held by the transferor may not constrain a transferee if it is probable when the option is written that it will not be exercised. Freestanding rights to reacquire transferred assets that are readily obtainable presumptively do not constrain the transferee from exchanging or pledging them and thus do not preclude sale accounting under paragraph 9(b).

33. Other rights or obligations to reacquire transferred assets, regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets, as discussed in paragraphs 50–54, thus precluding sale accounting under paragraph 9(c)(2).

Conditions That Constrain a Holder of Beneficial Interests in a Qualifying SPE

34. The considerations in paragraphs 29–32, about conditions that may or may not constrain a transferee that is not a qualifying SPE from pledging or exchanging the transferred assets, also extend to conditions that may or may not constrain a BIH from pledging or exchanging its beneficial interests in assets transferred to a qualifying SPE. For example, if BIHs agree to sell their beneficial interests in a qualifying SPE back to the transferor upon request at the price paid plus a stated return, that arrangement clearly conveys more than a trivial benefit to the transferor; sale accounting for the transfer to the qualifying SPE would be precluded if that agreement constrained a BIH from exchanging or pledging its beneficial interest.

Qualifying SPE

35. A qualifying SPE is a trust or other legal vehicle that meets all of the following conditions:

a. It is demonstrably distinct from the transferor (paragraph 36).

b. Its permitted activities (1) are significantly limited, (2) were entirely specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds, and (3) may be significantly changed only with the approval of the holders of at least a majority of the beneficial interests held by entities other than any transferor, its affiliates, and its agents (paragraphs 37 and 38).

c. It may hold only:

(1) Financial assets transferred to it that are passive in nature (paragraph 39).

(2) Passive derivative financial instruments that pertain to beneficial interests (other than another derivative financial instrument) issued or sold to parties other than the transferor, its affiliates, or its agents (paragraphs 39 and 40).

(3) Financial assets (for example, guarantees or rights to collateral) that would reimburse it if others were to fail to adequately service financial assets transferred to it or to timely pay obligations due to it and that it entered into when it was established, when assets were transferred to it, or when beneficial interests (other than derivative financial instruments) were issued by the SPE.

(4) Servicing rights related to financial assets that it holds.
(5) Temporarily, nonfinancial assets obtained in connection with the collection of financial assets that it holds (paragraph 41)

(6) Cash collected from assets that it holds and investments purchased with that cash pending distribution to holders of beneficial interests that are appropriate for that purpose (that is, money-market or other relatively risk-free instruments without options and with maturities no later than the expected distribution date).

d. If it can sell or otherwise dispose of noncash financial assets, it can do so only in automatic response to one of the following conditions:

(1) Occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected at the date of transfer to cause, the fair value of those financial assets to decline by a specified degree below the fair value of those assets when the SPE obtained them (paragraphs 42 and 43)

(2) Exercise by a BIH (other than the transferor, its affiliates, or its agents) of a right to put that holder’s beneficial interest back to the SPE (paragraph 44)

(3) Exercise by the transferor of a call or ROAP specified in the legal documents that established the SPE, transferred assets to the SPE, or created the beneficial interests in the transferred assets that it holds (paragraphs 51-54 and 85-88)

(4) Termination of the SPE or maturity of the beneficial interests in those financial assets on a fixed or determinable date that is specified at inception (paragraph 45).

Need to Be Demonstrably Distinct from the Transferor

36. A qualifying SPE is demonstrably distinct from the transferor only if it cannot be unilaterally dissolved by any transferor, its affiliates, or its agents and either (a) at least 10 percent of the fair value of its beneficial interests is held by parties other than any transferor, its affiliates, or its agents or (b) the transfer is a guaranteed mortgage securitization. 17 An ability to unilaterally dissolve an SPE can take many forms, including but not limited to holding sufficient beneficial interests to demand that the trustee dissolve the SPE, the right to call all the assets transferred to the SPE, and a right to call or a prepayment privilege on the beneficial interests held by other parties.

Limits on Permitted Activities

37. The powers of the SPE must be limited to those activities allowed by paragraph 35 for it to be a qualifying SPE. Many kinds of entities are not so limited. For example, any bank, insurance company, pension plan, or investment company has powers that cannot be sufficiently limited for it to be a qualifying SPE.

38. The BIHs other than any transferor, its affiliates, or its agents may have the ability to change the powers of a qualifying SPE. If the powers of a previously qualifying SPE are changed so that the SPE is no longer qualifying, unless the conditions in paragraph 9(b) are then met by the SPE itself and the conditions in paragraphs 9(a) and 9(c) continue to be met, that change would bring the transferred assets held in the SPE back under the control of the transferor (paragraph 55).

Limits on What a Qualifying SPE May Hold

39. A financial asset or derivative financial instrument is passive only if holding the asset or instrument does not involve its holder in making decisions other than the decisions inherent in servicing (paragraph 61). An equity instrument is not passive if the qualifying SPE can exercise the voting rights and is permitted to choose how to vote. Investments are not passive if through them, either in themselves or in combination with other investments or rights, the SPE or any
related entity, such as the transferor, its affiliates, or its agents, is able to exercise control or significant influence (as defined in generally accepted accounting principles for consolidation policy and for the equity method, respectively) over the investee. A derivative financial instrument is not passive if, for example, it includes an option allowing the SPE to choose to call or put other financial instruments; but other derivative financial instruments can be passive, for example, interest rate caps and swaps and forward contracts. Derivative financial instruments that result in liabilities, like other liabilities of a qualifying SPE, are a kind of beneficial interest in the qualifying SPE’s assets.

40. A derivative financial instrument pertains to beneficial interests (other than another derivative financial instrument) issued only if it:
   a. Is entered into (1) when the beneficial interests are issued by the qualifying SPE to parties other than the transferor, its affiliates, or its agents or sold to such other parties after being issued by the qualifying SPE to the transferor, its affiliates, or its agents or (2) when a passive derivative financial instrument needs to be replaced upon occurrence of an event or circumstance (specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds) outside the control of the transferor, its affiliates, or its agents, for example, when the counterparty to the derivative defaults or is downgraded below a specified threshold
   b. Has a notional amount that does not initially exceed the amount of those beneficial interests and is not expected to exceed them subsequently
   c. Has characteristics that relate to, and partly or fully but not excessively counteract, some risk associated with those beneficial interests or the related transferred assets.

41. A qualifying SPE may hold nonfinancial assets other than servicing rights only temporarily and only if those nonfinancial assets result from collecting the transferred financial assets. For example, a qualifying SPE could be permitted to temporarily hold foreclosed nonfinancial collateral. In contrast, an entity cannot be a qualifying SPE if, for example, it receives from a transferor significant secured financial assets likely to default with the expectation that it will foreclose on and profitably manage the securing nonfinancial assets. A qualifying SPE also may hold the residual value of a sales-type or a direct financing lease only to the extent that it is guaranteed at the inception of the lease either by the lessee or by a third party financially capable of discharging the obligations that may arise from the guarantee (paragraph 89).

Limits on Sales or Other Dispositions of Assets

42. Examples of requirements to sell, exchange, put, or distribute (hereinafter referred to collectively as dispose of) noncash financial assets that are permitted activities of a qualifying SPE—because they respond automatically to the occurrence of an event or circumstance that (a) is specified in the legal documents that established the SPE or created the beneficial interests in the transferred assets that it holds; (b) is outside the control of the transferor, its affiliates, or its agents; and (c) causes, or is expected to cause, the fair value of those assets to decline by a specified degree below the fair value of those assets when the qualifying SPE obtained them—include requirements to dispose of transferred assets in response to:
   a. A failure to properly service transferred assets that could result in the loss of a substantial third-party credit guarantee
   b. A default by the obligor
   c. A downgrade by a major rating agency of the transferred assets or of the underlying obligor to a rating below a specified minimum rating
   d. The involuntary insolvency of the transferor
   e. A decline in the fair value of the transferred assets to a specified value less than their fair value at the time they were transferred to the SPE.

43. The following are examples of powers or requirements to dispose of noncash financial assets that are not permitted activities of a qualifying SPE, because they do not respond automatically to the occurrence of a specified event or circumstance outside the control of the transferor, its affiliates, or its agents that causes, or is expected to cause, the fair value of those
transferred assets to decline by a specified degree below the fair value of those assets when the SPE obtained them:

a. A power that allows an SPE to choose to either dispose of transferred assets or hold them in response to a default, a downgrade, a decline in fair value, or a servicing failure

b. A requirement to dispose of marketable equity securities upon a specified decline from their “highest fair value” if that power could result in disposing of the asset in exchange for an amount that is more than the fair value of those assets at the time they were transferred to the SPE

c. A requirement to dispose of transferred assets in response to the violation of a nonsubstantive contractual provision (that is, a provision for which there is not a sufficiently large disincentive to ensure performance).

44. A qualifying SPE may dispose of transferred assets automatically to the extent necessary to comply with the exercise by a BiH (other than the transferor, its affiliates, or its agents) of its right to put beneficial interests back to the SPE in exchange for:

a. A full or partial distribution of those assets

b. Cash (which may require that the SPE dispose of those assets or issue beneficial interests to generate cash to fund settlement of the put)

c. New beneficial interests in those assets.

45. A qualifying SPE may have the power to dispose of assets to a party other than the transferor, its affiliate, or its agent on termination of the SPE or maturity of the beneficial interests, but only automatically on fixed or determinable dates that are specified at inception. For example, if an SPE is required to dispose of long-term mortgage loans and terminate itself at the earlier of (a) the specified maturity of beneficial interests in those mortgage loans or (b) the date of prepayment of a specified amount of the transferred mortgage loans, the termination date is a fixed or determinable date that was specified at inception. In contrast, if that SPE has the power to dispose of transferred assets on two specified dates and the SPE can decide which transferred assets to sell on each date, the termination date is not a fixed or determinable date that was specified at inception.

Qualifying SPEs and Consolidated Financial Statements

46. A qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates.

Maintaining Effective Control over Transferred Assets

Agreement to Repurchase or Redeem Transferred Assets

47. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor’s effective control over those assets under paragraph 9(c)(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 48).

b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 49).

c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.

d. The agreement is entered into concurrently with the transfer.

48. To be substantially the same, 18 the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
b. Identical form and type so as to provide the same risks and rights

c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities, similar remaining weighted-average maturities that result in approximately the same market yield)

d. Identical contractual interest rates

e. Similar assets as collateral

f. The same aggregate unpaid principal amount or principal amounts within accepted “good delivery” standards for the type of security involved.

49. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

Ability to Unilaterally Cause the Return of Specific Transferred Assets

50. Some rights to reacquire transferred assets (or to acquire beneficial interests in transferred assets held by a qualifying SPE), regardless of whether they constrain the transferee, may result in the transferor’s maintaining effective control over the transferred assets through the unilateral ability of the transferee to return the specific transferred assets. Such rights preclude sale accounting under paragraph 9(c)(2). For example, an attached call in itself would not constrain a transferee who is able, by exchanging or pledging the asset subject to that call, to obtain substantially all of its economic benefits. An attached call could result, however, in the transferor’s maintaining effective control over the transferred asset(s) because the attached call gives the transferor the ability to unilaterally cause the transferee to return it. In contrast, transfers of financial assets subject to calls embedded by the issuers of the financial instruments, for example, callable bonds or prepayable mortgage loans, do not preclude sale accounting. Such an embedded call does not result in the transferor’s maintaining effective control, because it is the issuer rather than the transferor who holds the call.

51. If the transferee is a qualifying SPE, it has met the conditions in paragraph 35(d) and therefore must be constrained from choosing to exchange or pledge the transferred assets. In that circumstance, any call held by the transferor is effectively attached to the assets and could—depending on the price and other terms of the call—maintain the transferor’s effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets. For example, a transferor’s unilateral ability to cause a qualifying SPE to return the transferred asset or otherwise dispose of specific transferred assets at will, or, for example, in response to its decision to exit a market or a particular activity, could provide the transferor with effective control over the transferred assets.

52. A call that is attached to transferred assets maintains the transferor’s effective control over those assets if, under its price and other terms, the call conveys more than a trivial benefit to the transferor. Similarly, any unilateral right to reclaim specific assets transferred to a qualifying SPE maintains the transferor’s effective control over those assets if the right conveys more than a trivial benefit to the transferor. A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless because that price is so far out of the money or for other reasons it is probable when the option is written that the transferor will not exercise it. Thus, for example, a call on specific assets transferred to a qualifying SPE at a price fixed at their principal amount maintains the transferor’s effective control over the assets subject to that call. Effective control over transferred assets can be present even if the right to reclaim is indirect. For example, an embedded call allows a transferor to buy back the beneficial interests of a qualifying SPE at a fixed price, then the transferor remains in effective control of the assets underlying those beneficial interests. A cleanup call, however, is permitted as an exception to that general principle.

53. A right to reclaim specific transferred assets by paying their fair value when reclaimed generally does not maintain effective control, because it does not convey a more than trivial benefit to the transferor. However, a transferor has maintained effective control if it has such a
right and also holds the residual interest in the transferred assets. For example, if a transferor can reclaim such assets at termination of the qualifying SPE by purchasing them in an auction, and thus at what might appear to be fair value, then sale accounting for the assets it can reclaim would be precluded. Such circumstances provide the transferor with a more than trivial benefit and effective control over the assets, because it can pay any price it chooses in the auction and recover any excess paid over fair value through its residual interest.

54. A transferor that has a right to reacquire transferred assets from a qualifying SPE does not maintain effective control if the reclaimed assets would be randomly selected and the amount of the assets reacquired is sufficiently limited (paragraph 87(a)), because that would not be a right to reacquire specific assets. Nor does a transferor maintain effective control through an obligation to reacquire transferred assets from a qualifying SPE if the transfer could occur only after a specified failure of the servicer to properly service the transferred assets that could result in the loss of a third-party guarantee (paragraph 42(a)) or only after a BIH other than the transferor, its affiliate, or its agent requires a qualifying SPE to repurchase that beneficial interest (paragraph 44(b)), because the transferor could not cause that reacquisition unilaterally.

Changes That Result in the Transferor’s Regaining Control of Assets Sold

55. A change in law, status of the transferee as a qualifying SPE, or other circumstance may result in the transferor’s regaining control of assets previously accounted for appropriately as having been sold, because one or more of the conditions in paragraph 9 are no longer met. Such a change, unless it arises solely from either the initial application of this Statement or a change in market prices (for example, an increase in price that moves into-the-money a freestanding call that was originally sufficiently out-of-the-money that it was judged not to constrain the transferee), is accounted for in the same manner as a purchase of the assets from the former transferee(s) in exchange for liabilities assumed (paragraph 11). After that change, the transferor recognizes in its financial statements those assets together with liabilities to the former transferee(s) or BIHs in those assets (paragraph 38). The transferor initially measures those assets and liabilities at fair value on the date of the change, as if the transferor purchased the assets and assumed the liabilities on that date. The former transferee would derecognize the assets on that date, as if it had sold the assets in exchange for a receivable from the transferor.

Measurement of Interests Held after a Transfer of Financial Assets

Assets Obtained and Liabilities Incurred as Proceeds

56. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

57. Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).
**Fair Values**

- Cash proceeds: $1,050
- Interest rate swap: 40
- Call option: 70
- Recourse obligation: 60

**Net Proceeds**

- Cash received: $1,050
- Plus: Call option: 70
  - Interest rate swap: 40
- Less: Recourse obligation: (60)

Net proceeds: $1,100

**Gain on Sale**

- Net proceeds: $1,100
- Carrying amount of loans sold: $1,000
- Gain on sale: $100

**Journal Entry**

- Cash: 1,050
- Interest rate swap: 40
- Call option: 70
  - Loans: 1,000
  - Recourse obligation: 60
  - Gain on sale: 100

To record transfer

Retained Interests

58. Other interests in transferred assets—those that are not part of the proceeds of the transfer—are retained interests over which the transferor has not relinquished control. They shall be measured at the date of the transfer by allocating the previous carrying amount between the assets sold, if any, and the retained interests, based on their relative fair values. Allocation procedures shall be applied to all transfers in which interests are retained, even those that do not qualify as sales. Examples of retained interests include securities backed by the transferred assets, undivided interests, servicing assets, and cash reserve accounts and residual interests in securitization trusts. If a transferor cannot determine whether an asset is a retained interest or proceeds from the sale, the asset shall be treated as proceeds from the sale and accounted for in accordance with paragraph 56.

59. If the retained interests are subordinated to more senior interests held by others, that subordination may concentrate into the retained interests most of the risks inherent in the transferred assets and shall be taken into consideration in estimating the fair value of the retained interests. For example, if the amount of the gain recognized, after allocation, on a securitization with a subordinated retained interest is greater than the gain would have been had the entire asset been sold, the transferor needs to be able to identify why that can occur. Otherwise, it is likely that the impact of the retained interest being subordinate to a senior interest has not been adequately considered in the determination of the fair value of the subordinated retained interest.

Illustration—Recording Transfers of Partial Interests

60. Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.
Fair values
Cash proceeds for nine-tenths sold $99
One-tenth interest retained \[\left(\frac{990 \div 9}{10}\right) \times 10\] 110

Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nine-tenths interest sold $990</td>
<td>90</td>
<td>$900</td>
</tr>
<tr>
<td>One-tenth interest retained 110</td>
<td>10</td>
<td>100</td>
</tr>
<tr>
<td>Total $1,100</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Gain on Sale
Net proceeds \$990
Carrying amount of loans sold 900
Gain on sale \$90

Journal Entry
Cash 990
Loans 900
Gain on sale 90
To record transfer

Servicing Assets and Liabilities

61. Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, collecting principal, interest, and escrow payments from borrowers; paying taxes and insurance from escrowed funds; monitoring delinquencies; executing foreclosure if necessary; temporarily investing funds pending distribution; remitting fees to guarantors, trustees, and others providing services; and accounting for and remitting principal and interest payments to the holders of beneficial interests in the financial assets. Servicing is inherent in all financial assets; it becomes a distinct asset or liability only when contractually separated from the underlying assets by sale or securitization of the assets with servicing retained or separate purchase or assumption of the servicing.

62. An entity that undertakes a contract to service financial assets shall recognize either a servicing asset or a servicing liability, with only one exception. (That exception is if the transferor transfers the assets in a guaranteed mortgage securitization, retains all of the resulting securities, and classifies them as debt securities held-to-maturity in accordance with Statement 115, in which case the servicing asset or liability may be reported together with the asset being serviced.) Each sale or securitization with servicing retained or separate purchase or assumption of servicing results in a servicing contract. A servicer of financial assets commonly receives the benefits of servicing—revenues from contractually specified servicing fees, late charges, and other ancillary sources, including “float,” all of which it is entitled to receive only if it performs the servicing—and incurs the costs of servicing the assets. Each servicing contract results in a servicing asset or servicing liability. Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability. (A servicing asset may become a servicing liability, or vice versa, if circumstances change, and the initial measure for servicing may be zero if the benefits of servicing are just adequate to compensate the servicer for its servicing responsibilities.)
63. A servicer that recognizes a servicing asset or servicing liability shall account for the contract to service financial assets separately from those assets, as follows:

   a. Report servicing assets separately from servicing liabilities in the statement of financial position (paragraph 13).
   b. Initially measure servicing assets retained in a sale or securitization of the assets being serviced at their allocated previous carrying amount based on relative fair values, if practicable, at the date of the sale or securitization (paragraphs 10, 58–60, and 68-72).
   c. Initially measure servicing assets purchased or servicing liabilities assumed at fair value (paragraph 13).
   d. Initially measure servicing liabilities undertaken in a sale or securitization at fair value, if practicable (paragraphs 11(b), 11(c), and 68-72).
   e. Account separately for rights to future interest income from the serviced assets that exceeds contractually specified servicing fees. Those rights are not servicing assets; they are financial assets, effectively interest-only strips to be accounted for in accordance with paragraph 14 of this Statement.
   f. Subsequently measure servicing assets by amortizing the amount recognized in proportion to and over the period of estimated net servicing income—the excess of servicing revenues over servicing costs (paragraph 13).
   g. Subsequently evaluate and measure impairment of servicing assets as follows:
      (1) Stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets. Those characteristics may include financial asset type, size, interest rate, date of origination, term, and geographic location.
      (2) Recognize impairment through a valuation allowance for an individual stratum. The amount of impairment recognized shall be the amount by which the carrying amount of servicing assets for a stratum exceeds their fair value. The fair value of servicing assets that have not been recognized shall not be used in the evaluation of impairment.
      (3) Adjust the valuation allowance to reflect changes in the measurement of impairment subsequent to the initial measurement of impairment. Fair value in excess of the carrying amount of servicing assets for that stratum, however, shall not be recognized. This Statement does not address when an entity should record a direct write-down of recognized servicing assets (paragraph 13).
   h. Subsequently measure servicing liabilities by amortizing the amount recognized in proportion to and over the period of estimated net servicing loss—the excess of servicing costs over servicing revenues. However, if subsequent events have increased the fair value of the liability above the carrying amount, for example, because of significant changes in the amount or timing of actual or expected future cash flows from the cash flows previously projected, the servicer shall revise its earlier estimates and recognize the increased obligation as a loss in earnings (paragraph 13).

64. As indicated above, transferors sometimes agree to take on servicing responsibilities when the future benefits of servicing are not expected to adequately compensate them for performing that servicing. In that circumstance, the result is a servicing liability rather than a servicing asset. For example, if in the transaction illustrated in paragraph 57 the transferor had agreed to service the loans without explicit compensation and it estimated the fair value of that servicing obligation at $50, net proceeds would be reduced to $1,050, gain on sale would be reduced to $50, and the transferor would report a servicing liability of $50.

Illustration—Sale of Receivables with Servicing Retained

65. Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is
considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

Fair values
Cash proceeds $1,000
Servicing asset 40
Interest-only strip receivable 60

Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th></th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$ 1,000</td>
<td>91.0</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3.6</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
<td>5.4</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Gain on Sale
Net proceeds $1000
Carrying amount of loans sold 910
Gain on sale 90

Journal Entries
Cash 1000
Loans 910
Gain on sale 90
To record transfer
Servicing asset 36
Interest-only strip receivable 54
Loans 90
To record servicing asset and interest-only strip receivable
Interest-only strip receivable 6
Equity 6
To begin to subsequently measure interest-only strip receivable like an available-for-sale security (paragraph 14)

66. The previous illustration demonstrates how a transferor would account for a simple sale or securitization in which servicing is retained. Company C might instead transfer the financial assets to a corporation or a trust that is a qualifying SPE. The qualifying SPE then securitizes the loans by selling beneficial interests to the public. The qualifying SPE pays the cash proceeds to the original transferor, which accounts for the transfer as a sale and derecognizes the financial assets assuming that the criteria in paragraph 9 are met. Securitizations often combine the elements shown in paragraphs 57, 60, and 65, as illustrated below.

Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

67. Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract
stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

**Fair values**

<table>
<thead>
<tr>
<th>Category</th>
<th>Fair Value</th>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest sold</td>
<td>$910</td>
<td>83</td>
<td>$830</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td>8</td>
<td>80</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td>9</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$1,100</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Net Proceeds**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$90</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$91</td>
</tr>
</tbody>
</table>

**Carrying Amount Based on Relative Fair Values**

| Interest sold             | 83% | $830 |
| Servicing asset           | 8%  | 80   |
| One-tenth interest retained| 9%  | 90   |
| **Total**                 | 100%| $1,000 |

**Gain on Sale**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$910</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>830</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$80</td>
</tr>
</tbody>
</table>

**Journal Entries**

- **Cash**
  - 900
- **Call option**
  - 70
- **Loans**
  - 830
- **Recourse obligation**
  - 60
- **Gain on sale**
  - 80
- **To record transfer**
- **Servicing asset**
  - 80
- **Loans**
  - 80
- **To record servicing asset**

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

**Fair Value**

68. The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If a
If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. The estimate of fair value shall consider prices for similar assets and liabilities and the results of valuation techniques to the extent available in the circumstances. Examples of valuation techniques include the present value of estimated future cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis. Valuation techniques for measuring financial assets and liabilities and servicing assets and liabilities shall be consistent with the objective of measuring fair value. Those techniques shall incorporate assumptions that market participants would use in their estimates of values, future revenues, and future expenses, including assumptions about interest rates, default, prepayment, and volatility. In measuring financial liabilities and servicing liabilities at fair value, the objective is to estimate the value of the assets required currently to (a) settle the liability with the holder or (b) transfer a liability to an entity of comparable credit standing.

Estimates of expected future cash flows, if used to estimate fair value, shall be based on reasonable and supportable assumptions and projections. All available evidence shall be considered in developing estimates of expected future cash flows. The weight given to the evidence shall be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for either the amount or timing of possible cash flows, the likelihood of possible outcomes shall be considered either directly, if applying an expected cash flow approach, or indirectly through the risk-adjusted discount rate, if determining the best estimate of future cash flows.

If it is not practicable to estimate fair values of assets, the transferor shall record those assets at zero. If it is not practicable to estimate the fair values of liabilities, the transferor shall recognize no gain on the transaction and shall record those liabilities at the greater of:

a. The excess, if any, of (1) the fair values of assets obtained less the fair values of other liabilities incurred, over (2) the sum of the carrying values of the assets transferred

b. The amount that would be recognized in accordance with FASB Statement No. 5, Accounting for Contingencies, as interpreted by FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>1,100</td>
<td>1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value
**Net Proceeds**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,120</td>
</tr>
</tbody>
</table>

**Carrying Amount Based on Relative Fair Values (Case 1)**

<table>
<thead>
<tr>
<th></th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,060 100</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0 0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$1,060 100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

**Carrying Amount Based on Relative Fair Values (Case 2)**

<table>
<thead>
<tr>
<th></th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,120 97</td>
<td>$970</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40 3</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>$1,160 100</td>
<td>$1,000</td>
</tr>
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</table>

**Journal Entries**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0*</td>
<td>30</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>150†</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

**Securitizations**

73. Financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, and other revolving charge accounts are assets commonly transferred in securitizations. Securitizations of mortgage loans may include pools of single-family residential mortgages or other types of real estate mortgage loans, for example, multifamily residential mortgages and commercial property mortgages. Securitizations of loans secured by chattel mortgages on automotive vehicles as well as other equipment (including direct financing or sales-type leases) also are common. Both financial and nonfinancial assets can be securitized; life insurance policy loans, patent and copyright royalties, and even taxi medallions also have been securitized. But securitizations of nonfinancial assets are outside the scope of this Statement.

74. An originator of a typical securitization (the transferor) transfers a portfolio of financial assets to an SPE, commonly a trust. In "pass-through" and "pay-through" securitizations, receivables are transferred to the SPE at the inception of the securitization, and no further transfers are made; all cash collections are paid to the holders of beneficial interests in the SPE. In "revolving-period" securitizations, receivables are transferred at the inception and also periodically (daily or monthly) thereafter for a defined period (commonly three to eight years), referred to as the revolving period. During the revolving period, the SPE uses most of the cash collections to purchase additional receivables from the transferor on prearranged terms.
75. Beneficial interests in the SPE are sold to investors and the proceeds are used to pay the transferor for the assets transferred. Those beneficial interests may comprise either a single class having equity characteristics or multiple classes of interests, some having debt characteristics and others having equity characteristics. The cash collected from the portfolio is distributed to the investors and others as specified by the legal documents that established the SPE.

76. Pass-through, pay-through, and revolving-period securitizations that meet the criteria in paragraph 9 qualify for sale accounting under this Statement. All financial assets obtained or retained and liabilities incurred by the originator of a securitization that qualifies as a sale shall be recognized and measured as provided in paragraph 11; that includes the implicit forward contract to sell new receivables during a revolving period, which may become valuable or onerous to the transferor as interest rates and other market conditions change.

Revolving-Period Securitizations

77. The value of the forward contract implicit in a revolving-period securitization arises from the difference between the agreed-upon rate of return to investors on their beneficial interests in the trust and current market rates of return on similar investments. For example, if the agreed-upon annual rate of return to investors in a trust is 6 percent, and later market rates of return for those investments increased to 7 percent, the forward contract’s value to the transferor (and burden to the investors) would approximate the present value of 1 percent of the amount of the investment for each year remaining in the revolving structure after the receivables already transferred have been collected. If a forward contract to sell receivables is entered into at the market rate, its value at inception may be zero. Changes in the fair value of the forward contract are likely to be greater if the investors receive a fixed rate than if the investors receive a rate that varies based on changes in market rates.

78. Gain or loss recognition for revolving-period receivables sold to a securitization trust is limited to receivables that exist and have been sold. Recognition of servicing assets or liabilities for revolving-period receivables is similarly limited to the servicing for the receivables that exist and have been transferred. As new receivables are sold, rights to service them become assets or liabilities and are recognized.

79. Revolving-period securitizations may use either a discrete trust, used for a single securitization, or a master trust, used for many securitizations. To achieve another securitization using an existing master trust, a transferor first transfers additional receivables to the trust and then sells additional ownership interests in the trust to investors. Adding receivables to a master trust, in itself, is neither a sale nor a secured borrowing under paragraph 9, because that transfer only increases the transferor’s beneficial interest in the trust’s assets. A sale or secured borrowing does not occur until the transferor receives consideration other than beneficial interests in the transferred assets. Transfers that result in an exchange of cash, that is, either transfers that in essence replace previously transferred receivables that have been collected or sales of beneficial interests to outside investors, are transfers in exchange for consideration other than beneficial interests in the transferred assets and thus are accounted for as sales (if they satisfy all the criteria in paragraph 9) or as secured borrowings.

Isolation of Transferred Assets in Securitizations

80. A securitization carried out in one transfer or a series of transfers may or may not isolate the transferred assets beyond the reach of the transferor and its creditors. Whether it does depends on the structure of the securitization transaction taken as a whole, considering such factors as the type and extent of further involvement in arrangements to protect investors from credit and interest rate risks, the availability of other assets, and the powers of bankruptcy courts or other receivers.

81. In certain securitizations, a corporation that, if it failed, would be subject to the U.S. Bankruptcy Code transfers financial assets to a special-purpose trust in exchange for cash. The
trust raises that cash by issuing to investors beneficial interests that pass through all cash received from the financial assets, and the transferor has no further involvement with the trust or the transferred assets. The Board understands that those securitizations generally would be judged as having isolated the assets, because in the absence of any continuing involvement there would be reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

82. In other securitizations, a similar corporation transfers financial assets to an SPE in exchange for cash and beneficial interests in the transferred assets. That entity raises the cash by issuing to investors commercial paper that gives them a senior interest in cash received from the financial assets. The beneficial interests retained by the transferring corporation represent a junior interest to be reduced by any credit losses on the financial assets in trust. The commercial paper interests are highly rated by credit rating agencies only if both (a) the credit enhancement from the junior interest is sufficient and (b) the transferor is highly rated. Depending on facts and circumstances, the Board understands that those "single-step" securitizations often would be judged in the United States as not having isolated the assets, because the nature of the continuing involvement may make it difficult to obtain reasonable assurance that the transfer would be found to be a true sale at law that places the assets beyond the reach of the transferor and its creditors in U.S. bankruptcy (paragraph 113). If the transferor fell into bankruptcy and the transfer was found not to be a true sale at law, investors in the transferred assets might be subjected to an automatic stay that would delay payments due them, and they might have to share in bankruptcy expenses and suffer further losses if the transfer was recharacterized as a secured loan.

83. Still other securitizations use two transfers intended to isolate transferred assets beyond the reach of the transferor and its creditors, even in bankruptcy. In those "two-step" structures:
   a. First, the corporation transfers financial assets to a special-purpose corporation that, although wholly owned, is so designed that the possibility that the transferor or its creditors could reclaim the assets is remote. This first transfer is designed to be judged to be a true sale at law, in part because the transferor does not provide "excessive" credit or yield protection to the special-purpose corporation, and the Board understands that transferred assets are likely to be judged beyond the reach of the transferor or the transferor's creditors even in bankruptcy.
   b. Second, the special-purpose corporation transfers the assets to a trust or other legal vehicle with a sufficient increase in the credit or yield protection on the second transfer (provided by a junior retained beneficial interest or other means) to merit the high credit rating sought by third-party investors who buy senior beneficial interests in the trust. Because of that aspect of its design, that second transfer might not be judged to be a true sale at law and, thus, the transferred assets could at least in theory be reached by a bankruptcy trustee for the special-purpose corporation.
   c. However, the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets.

The Board understands that the "two-step" securitizations described above, taken as a whole, generally would be judged under present U.S. law as having isolated the assets beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

84. The powers of receivers for entities not subject to the U.S. Bankruptcy Code (for example, banks subject to receivership by the FDIC) vary considerably, and therefore some receivers may be able to reach financial assets transferred under a particular arrangement and others may not. A securitization may isolate transferred assets from a transferor subject to such a
receiver and its creditors even though it is accomplished by only one transfer directly to an SPE that issues beneficial interests to investors and the transferor provides credit or yield protection. For entities that are subject to other possible bankruptcy, conservatorship, or other receivership procedures in the United States or other jurisdictions, judgments about whether transferred assets have been isolated need to be made in relation to the powers of bankruptcy courts or trustees, conservators, or receivers in those jurisdictions.


85. Many transfers of financial assets in securitizations empower the transferor to reclaim assets subject to certain restrictions. Such a power is sometimes called a removal-of-accounts provision (ROAP). Whether a ROAP precludes sale accounting depends on whether the ROAP results in the transferor’s maintaining effective control over specific transferred assets (paragraphs 9(c)(2) and 51-54).

86. The following are examples of ROAPs that preclude transfers from being accounted for as sales:
   a. An unconditional ROAP or repurchase agreement that allows the transferor to specify the assets that may be removed, because such a provision allows the transferor unilaterally to remove specific assets
   b. A ROAP conditioned on a transferor’s decision to exit some portion of its business, because whether it can be triggered by canceling an affinity relationship, spinning off a business segment, or accepting a third party’s bid to purchase a specified (for example, geographic) portion of the transferor’s business, such a provision allows the transferor unilaterally to remove specific assets.

87. The following are examples of ROAPs that do not preclude transfers from being accounted for as sales:
   a. A ROAP for random removal of excess assets, if the ROAP is sufficiently limited so that the transferor cannot remove specific transferred assets, for example, by limiting removals to the amount of the transferor’s retained interest and to one removal per month
   b. A ROAP for defaulted receivables, because the removal would be allowed only after a third party’s action (default) and could not be caused unilaterally by the transferor
   c. A ROAP conditioned on a third-party cancellation, or expiration without renewal, of an affinity or private-label arrangement, because the removal would be allowed only after a third party’s action (cancellation) or decision not to act (expiration) and could not be caused unilaterally by the transferor.

88. A ROAP that can be exercised only in response to a third party’s action that has not yet occurred does not maintain the transferor’s effective control over assets potentially subject to that ROAP. However, when a third party’s action (such as default or cancellation) or decision not to act (expiration) occurs that allows removal of assets to be initiated solely by the transferor, the transferor must recognize any assets subject to the ROAP, whether the ROAP is exercised or not. If the ROAP is exercised, the assets are recognized because the transferor has reclaimed the assets. If the ROAP is not exercised, the assets are recognized because the transferor now can unilaterally cause the qualifying SPE to return those specific assets and, therefore, the transferor once again has effective control over those transferred assets (paragraph 55).

Securities Lending Transactions

91. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer’s failure to deliver securities sold. Transferees (“borrowers”) of securities generally are required to provide “collateral” to the transferor (“lender”) of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities “borrowed.” If the “collateral” is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or “rebated” to the transferee. If the “collateral” is other than...
cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

92. In some securities lending transactions, the criteria in paragraph 9 are met, including the effective control criterion in paragraph 9(c), and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the cash "collateral" and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

93. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 47-49). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 15(a), and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

94. The transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.

Illustration—Securities Lending Transaction Treated as a Secured Borrowing

95. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

**Facts**

- Transferor's carrying amount and fair value of security loaned: $1,000
- Cash "collateral": 1,020
- Transferor's return from investing cash collateral at a 5 percent annual rate: 5
- Transferor's rebate to the securities borrower at a 4 percent annual rate: 4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

**Journal Entries for the Transferor**

*At inception:*

<table>
<thead>
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<th>Description</th>
<th>Amount</th>
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<tbody>
<tr>
<td>Cash</td>
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<tr>
<td>Payable under securities loan agreements</td>
<td>1,020</td>
</tr>
<tr>
<td>To record the receipt of cash collateral</td>
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<tr>
<td>Securities pledged to creditors</td>
<td>1,000</td>
</tr>
<tr>
<td>Securities</td>
<td>1,000</td>
</tr>
<tr>
<td>To reclassify loaned securities that the secured party has</td>
<td></td>
</tr>
</tbody>
</table>
the right to sell or repledge

Money market instrument  1,020
Cash  1,020
To record investment of cash collateral

At conclusion:
Cash 1,025
Interest  5
Money market instrument  1,020
To record results of investment

Securities 1,000
Securities pledged to creditors  1,000
To record return of security

Payable under securities loan agreements 1,020
Interest ("rebate")  4
Cash  1,024
To record repayment of cash collateral plus interest

Journal Entries for the Transferee
At inception:
Receivable under securities loan agreements 1,020
Cash  1,020
To record transfer of cash collateral

Cash 1,000
Obligation to return borrowed securities  1,000
To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:
Obligation to return borrowed securities 1,000
Cash  1,000
To record the repurchase of securities borrowed

Cash 1,024
Receivable under securities loan agreements  1,020
Interest revenue ("rebate")  4
To record the receipt of cash collateral and rebate interest

Repurchase Agreements and "Wash Sales"

96. Government securities dealers, banks, other financial institutions, and corporate investors commonly use repurchase agreements to obtain or use short-term funds. Under those agreements, the transferor ("repo party") transfers a security to a transferee ("repo counterparty" or "reverse party") in exchange for cash 23 and concurrently agrees to reacquire that security at a future date for an amount equal to the cash exchanged plus a stipulated "interest" factor.

97. Repurchase agreements can be effected in a variety of ways. Some repurchase agreements are similar to securities lending transactions in that the transferee has the right to sell or repledge the securities to a third party during the term of the repurchase agreement. In other repurchase agreements, the transferee does not have the right to sell or repledge the securities during the term of the repurchase agreement. For example, in a tri-party repurchase agreement, the transferor transfers securities to an independent third-party custodian that holds the securities
during the term of the repurchase agreement. Also, many repurchase agreements are for short terms, often overnight, or have indefinite terms that allow either party to terminate the arrangement on short notice. However, other repurchase agreements are for longer terms, sometimes until the maturity of the transferred asset. Some repurchase agreements call for repurchase of securities that need not be identical to the securities transferred.

98. If the criteria in paragraph 9 are met, including the criterion in paragraph 9(c)(1), the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that shall be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

99. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

100. As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 48) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

101. If a transferor has transferred securities to an independent third-party custodian, or to a transferee, under conditions that preclude the transferee from selling or repledging the assets during the term of the repurchase agreement (as in most tri-party repurchase agreements), the transferor has not surrendered control over those assets.

Loan Syndications

102. Borrowers often borrow amounts greater than any one lender is willing to lend. Therefore, it is common for groups of lenders to jointly fund those loans. That may be accomplished by a syndication under which several lenders share in lending to a single borrower, but each lender loans a specific amount to the borrower and has the right to repayment from the borrower.

103. A loan syndication is not a transfer of financial assets. Each lender in the syndication shall account for the amounts it is owed by the borrower. Repayments by the borrower may be made to a lead lender that then distributes the collections to the other lenders of the syndicate. In those circumstances, the lead lender is simply functioning as a servicer and, therefore, shall not recognize the aggregate loan as an asset.

Loan Participations

104. Groups of banks or other entities also may jointly fund large borrowings through loan participations in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other entities.

105. Transfers by the originating lender may take the legal form of either assignments or participations. The transfers are usually on a nonrecourse basis, and the transferor ("originating lender") continues to service the loan. The transferee ("participating entity") may or may not have
the right to sell or transfer its participation during the term of the loan, depending upon the terms of the participation agreement.

106. If the loan participation agreement gives the transferee the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the transferee shall be accounted for by the transferor as sales of financial assets. A transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor if other potential willing buyers exist is a limitation on the transferee's rights but presumptively does not constrain a transferee from exercising its right to pledge or exchange. However, if the loan participation agreement constrains the transferees from pledging or exchanging their participations, the transferor presumptively receives a more than trivial benefit, has not relinquished control over the loan, and shall account for the transfers as secured borrowings.

Factoring Arrangements

112. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the factor) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 shall be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor.

Transfers of Receivables with Recourse

113. In a transfer of receivables with recourse, the transferor provides the transferee with full or limited recourse. The transferor is obligated under the terms of the recourse provision to make payments to the transferee or to repurchase receivables sold under certain circumstances, typically for defaults up to a specified percentage. The effect of a recourse provision on the application of paragraph 9 may vary by jurisdiction. In some jurisdictions, transfers with full recourse may not place transferred assets beyond the reach of the transferor and its creditors, but transfers with limited recourse may. A transfer of receivables with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation, if the criteria in paragraph 9 are met. Otherwise, a transfer of receivables with recourse shall be accounted for as a secured borrowing.

Extinguishments of Liabilities

114. If a creditor releases a debtor from primary obligation on the condition that a third party assumes the obligation and that the original debtor becomes secondarily liable, that release extinguishes the original debtor's liability. However, in those circumstances, whether or not explicit consideration was paid for that guarantee, the original debtor becomes a guarantor. As a guarantor, it shall recognize a guarantee obligation in the same manner as would a guarantor that had never been primarily liable to that creditor, with due regard for the likelihood that the third party will carry out its obligations. The guarantee obligation shall be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

RELEVANT LITERATURE

Statutory Accounting

- Statement of Statutory Accounting Principles No. 18—Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- Statement of Statutory Accounting Principles No. 33—Securitization
- Statement of Statutory Accounting Principles No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements
- NAIC Purposes and Procedures of the Securities Valuation Office
Generally Accepted Accounting Principles

- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- AICPA Statement of Position 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as used In Certain Audit Guides and a Statement of Position*
- FASB Emerging Issues Task Force No. 87-34, *Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- FASB Emerging Issues Task Force No. 88-11, *Allocation of Recorded Investment When a Loan as Part of a Loan is Sold*
- FASB Emerging Issues Task Force No. 88-18, *Sales of Future Revenues*
- FASB Emerging Issues Task Force No. 88-22, *Securitization of Credit Card and Other Receivable Portfolios*
- FASB Emerging Issues Task Force No. 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement*
- FASB Emerging Issues Task Force No. 95-5, *Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights*
- FASB Emerging Issues Task Force No. 96-19, *Debtor’s Accounting for a Modification or Exchange of Debt Instruments*
EXHIBIT A - GLOSSARY

Asset Securitization

An asset securitization is the process of converting assets which would normally serve as collateral for a loan into securities. The largest category of securitized assets is real estate mortgage loans, which serve as collateral for mortgage-backed securities.

Beneficial interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through, premiums due to guarantors, commercial paper obligations and residual interests, whether in the form of debt or equity.

Beneficial interest holder (“BIH”)

Holder of beneficial interests

Cleanup call

An option held by the servicer, which may be the transferor, to purchase transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents in a qualifying SPE (or in a series of beneficial interests in transferred assets within a qualifying SPE), when the amount of outstanding assets falls to a level at which the cost of servicing those assets becomes burdensome in relation to the benefits or servicing.

Collateral

Personal or real property in which a security interest has been given.

Derecognize

Remove previously recognized assets or liabilities from the balance sheet.

Derivative financial instrument

A derivative instrument (as defined in SSAP No. 86—Accounting for Derivative Instruments and Hedging, Income Generation, and Replication (Synthetic Asset) Transactions) that is a financial instrument (refer to SSAP No. 27, paragraph 2).

Embedded call (See Issue Paper on FAS 140 paragraphs 50 and 52)

A call option held by the issuer of a financial instrument that is part of and trades with the underlying instrument. For example, a bond may allow the issuer to call it by posting a public notice well before its stated maturity that asks the current holder to submit it for early redemption and provides that interest ceases to accrue on the bond after the early redemption date. Rather than being an obligation of the initial purchaser of the bond, an embedded call trades with and diminishes the value of the underlying bond.

Financial asset

Cash, evidence of an ownership interest in an entity, or a contract that conveys to a second entity a contractual right (a) to receive cash or another financial instrument from a first entity or (b) to exchange
other financial instruments on potentially favorable terms with the first entity.

**Financial liability**

A contract that imposes on one entity a contractual obligation (a) to deliver cash or another financial instrument to a second entity or (b) to exchange other financial instruments on potentially unfavorable terms with the second entity.

**Guaranteed mortgage securitization**

A securitization of mortgage loans which includes a substantive guarantee by a third party.

**Proceeds**

Cash, derivatives, or other assets that are obtained in a transfer of financial assets, less any liabilities incurred.

**Recourse**

The right of a transferee of receivables to receive payment from the transferor of those receivables for (a) failure of debtors to pay when due, (b) the effects of prepayments, or (c) adjustments resulting from defects in the eligibility of the transferred receivables.

**Residual**

Residuals are a class of retained or purchased beneficial interests that have rights to the last cash flows from the pool of securitized assets and are not rated by a NRSRO. Residuals are to be carried at fair value with the difference between fair value and the allocated cost basis recognized as an unrealized gain or loss;

**Securitization**

The process by which financial assets are transformed into securities.

**Security interest**

A form of interest in property that provides that upon default of the obligation for which the security interest is given, the property may be sold in order to satisfy that obligation.

**Seller**

A transferor that relinquishes control over financial assets by transferring them to a transferee in exchange for consideration.

**Servicing asset**

A contract to service financial assets under which the estimated future revenues from contractually specified servicing fees, late charges, and other ancillary revenues are expected to more than adequately compensate the servicer for performing the servicing. A servicing contract is either (a) undertaken in conjunction with selling or securitizing the financial assets being serviced or (b) purchased or assumed separately.
Servicing liability

A contract to service financial assets under which the estimated future revenues from stated servicing fees, late charges, and other ancillary revenues are not expected to adequately compensate the servicer for performing the servicing.

Transfer

The conveyance of a noncash financial asset by and to someone other than the issuer of that financial asset. Thus, a transfer includes selling a receivable, putting it into a securitization trust, or posting it as collateral but excludes the origination of that receivable, the settlement of that receivable, or the restructuring of that receivable into a security in a troubled debt restructuring.

Transferee

An entity that receives a financial asset, a portion of a financial asset, or a group of financial assets from a transferor.

Transferor

An entity that transfers a financial asset, a portion of a financial asset, or a group of financial assets that it controls to another entity.

Undivided interest

Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal.

Unrestricted collateral

Securities received that may be sold or repledged and which were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract.

Unilateral ability (See Issue Paper on FAS 140 paragraphs 50 and 51)

A capacity for action not dependent on the actions (or failure to act) of any other party.
EXHIBIT B - ILLUSTRATIONS

1. Illustration—Recording Transfers with Proceeds of Cash, Derivatives, and Other Liabilities

Company A sells loans with a fair value of $1,100 and a carrying amount of $1,000. Company A retains no servicing responsibilities but obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and assumes a limited recourse obligation to repurchase delinquent loans.

Company A agrees to provide the transferee a return at a floating rate of interest even though the contractual terms of the loan are fixed rate in nature (that provision is effectively an interest rate swap).

**Fair Values**

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<tr>
<td>Interest rate swap</td>
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<tr>
<td>Call option</td>
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<td>Recourse obligation</td>
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**Net Proceeds**

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<tbody>
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<td>Cash received</td>
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<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Interest rate swap</td>
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<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
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<tr>
<td>Net proceeds</td>
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**Gain on Sale**

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<tr>
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**Journal Entry**

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<td>Gain on sale</td>
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</table>

*To record transfer*

2. Illustration—Recording Transfers of Partial Interests

Company B sells a pro rata nine-tenths interest in loans with a fair value of $1,100 and a carrying amount of $1,000. There is no servicing asset or liability, because Company B estimates that the benefits of servicing are just adequate to compensate it for its servicing responsibilities.

**Fair values**

<p>| |</p>
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds for nine-tenths sold</td>
</tr>
<tr>
<td>One-tenth interest retained [($990 ÷ 9/10) × 1/10]</td>
</tr>
</tbody>
</table>

IP 122-72
### Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value</td>
<td></td>
</tr>
<tr>
<td>Nine-tenths interest sold</td>
<td>$ 990</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>110</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

#### Gain on Sale

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$ 990</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>900</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$ 90</td>
</tr>
</tbody>
</table>

#### Journal Entry

- **Cash**: 990
- **Loans**: 900
- **Gain on sale**: 90

*To record transfer*

3. **Illustration—Sale of Receivables with Servicing Retained**

Company C originates $1,000 of loans that yield 10 percent interest income for their estimated lives of 9 years. Company C sells the $1,000 principal plus the right to receive interest income of 8 percent to another entity for $1,000. Company C will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the right to receive half of the interest income not sold. The remaining half of the interest income not sold is considered an interest-only strip receivable. At the date of the transfer, the fair value of the loans, including servicing, is $1,100. The fair value of the servicing asset is $40.

#### Fair values

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
</tbody>
</table>

#### Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th>Percentage of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Value</td>
<td></td>
</tr>
<tr>
<td>Loans sold</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
</tr>
<tr>
<td>Interest-only strip receivable</td>
<td>60</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,100</td>
</tr>
</tbody>
</table>

#### Gain on Sale

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net proceeds</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Carrying amount of loans sold</td>
<td>910</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$ 90</td>
</tr>
</tbody>
</table>
Journal Entries

Cash 1000
Loans 910
Gain on sale 90

To record transfer

Servicing asset 36
Interest-only strip receivable 54
Loans 90

To record servicing asset and interest-only strip receivable

Interest-only strip receivable 6
Equity 6

To begin to subsequently measure interest-only strip receivable like an available-for-sale security (FAS 140 paragraph 14)

4. Illustration—Recording Transfers of Partial Interests with Proceeds of Cash, Derivatives, Other Liabilities, and Servicing

Company D originates $1,000 of prepayable loans that yield 10 percent interest income for their 9-year expected lives. Company D sells nine-tenths of the principal plus interest of 8 percent to another entity. Company D will continue to service the loans, and the contract stipulates that its compensation for performing the servicing is the 2 percent of the interest income not sold. Company D obtains an option to purchase from the transferee loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase delinquent loans.

Fair values

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$900</td>
<td></td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

Net Proceeds

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$900</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$910</td>
</tr>
</tbody>
</table>

Carrying Amount Based on Relative Fair Values

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest sold</td>
<td>$910</td>
<td>83</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>90</td>
<td>8</td>
</tr>
<tr>
<td>One-tenth interest retained</td>
<td>100</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>$1,100</td>
<td>100</td>
</tr>
</tbody>
</table>
Gain on Sale
Net proceeds $ 910
Carrying amount of loans sold 830
Gain on sale $ 80

Journal Entries
Cash 900
Call option 70
Loans 830
Recourse obligation 60
Gain on sale 80
To record transfer
Servicing asset 80
Loans 80
To record servicing asset

At the time of the transfer, Company D reports its one-tenth retained interest in the loans at its allocated carrying amount of $90.

5. Illustration—Recording Transfers If It Is Not Practicable to Estimate a Fair Value

Company E sells loans with a carrying amount of $1,000 to another entity for cash plus a call option to purchase loans similar to the loans sold (which are readily obtainable in the marketplace) and incurs a limited recourse obligation to repurchase any delinquent loans. Company E undertakes to service the transferred assets for the other entity. In Case 1, Company E finds it impracticable to estimate the fair value of the servicing contract, although it is confident that servicing revenues will be more than adequate compensation for performing the servicing. In Case 2, Company E finds it impracticable to estimate the fair value of the recourse obligation.

<table>
<thead>
<tr>
<th>Fair Values</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>XX*</td>
<td>40</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>XX*</td>
</tr>
<tr>
<td>Fair value of loans transferred</td>
<td>$1,100</td>
<td>$1,100</td>
</tr>
</tbody>
</table>

* Not practicable to estimate fair value

<table>
<thead>
<tr>
<th>Net Proceeds</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>$1,050</td>
<td>$1,050</td>
</tr>
<tr>
<td>Plus: Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Less: Recourse obligation</td>
<td>(60)</td>
<td>XX</td>
</tr>
<tr>
<td>Net proceeds</td>
<td>$1,060</td>
<td>$1,120</td>
</tr>
</tbody>
</table>
Carrying Amount Based on Relative Fair Values (Case 1)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$1,060</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Carrying Amount Based on Relative Fair Values (Case 2)

<table>
<thead>
<tr>
<th></th>
<th>Fair Value</th>
<th>Percentage Of Total Fair Value</th>
<th>Allocated Carrying Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans sold</td>
<td>$1,120</td>
<td>97</td>
<td>$970</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>40</td>
<td>3</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>$1,160</td>
<td>100</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Journal Entries

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,050</td>
<td>1,050</td>
</tr>
<tr>
<td>Servicing asset</td>
<td>0*</td>
<td>30</td>
</tr>
<tr>
<td>Call option</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td>Loans</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Recourse obligation</td>
<td>60</td>
<td>150†</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>60</td>
<td>0</td>
</tr>
<tr>
<td>To record transfer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Assets shall be recorded at zero if an estimate of the fair value of the assets is not practicable.
† The amount recorded as a liability in this example equals the sum of the known assets less the fair value of the known liabilities, that is, the amount that results in no gain or loss.

6. The following example illustrates the accounting for a securities lending transaction treated as a secured borrowing, in which the securities borrower sells the securities upon receipt and later buys similar securities to return to the securities lender:

Facts

- Transferor’s carrying amount and fair value of security loaned: $1,000
- Cash “collateral”: 1,020
- Transferor’s return from investing cash collateral at a 5 percent annual rate: 5
- Transferor’s rebate to the securities borrower at a 4 percent annual rate: 4

For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

Journal Entries for the Transferor

At inception:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,020</td>
</tr>
<tr>
<td>Payable under securities loan agreements</td>
<td>1,020</td>
</tr>
<tr>
<td>To record the receipt of cash collateral</td>
<td></td>
</tr>
</tbody>
</table>
Securities pledged to creditors 1,000
Securities 1,000
To reclassify loaned securities that the secured party has the right to sell or repledge

Money market instrument 1,020
Cash 1,020
To record investment of cash collateral

At conclusion:
Cash 1,025
Interest 5
Money market instrument 1,020
To record results of investment

Securities 1,000
Securities pledged to creditors 1,000
To record return of security

Payable under securities loan agreements 1,020
Interest ("rebate") 4
Cash 1,024
To record repayment of cash collateral plus interest

Journal Entries for the Transferee
At inception:
Receivable under securities loan agreements 1,020
Cash 1,020
To record transfer of cash collateral

Cash 1,000
Obligation to return borrowed securities 1,000
To record sale of borrowed securities to a third party and the resulting obligation to return securities that it no longer holds

At conclusion:
Obligation to return borrowed securities 1,000
Cash 1,000
To record the repurchase of securities borrowed

Cash 1,024
Receivable under securities loan agreements 1,020
Interest revenue ("rebate") 4
To record the receipt of cash collateral and rebate interest

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Statutory Issue Paper No. 123

Accounting for Pensions, A Replacement of SSAP No. 8

STATUS:
Finalized September 15, 2003

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for employers’ pension obligations is provided in Statement of Statutory Accounting Principles (SSAP) No. 8—Pensions (SSAP No. 8). This issue paper supersedes the conclusions reached in SSAP No. 8 and incorporates the guidance in INT 99-24 – Accounting for Restructuring Charges, INT 99-26 – Offsetting Pension Assets and Liabilities, INT 01-16 – Measurement Date for SSAP No. 8 Actuarial Valuations, INT 01-17 – Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans, as well as some of the guidance in INT 02-18 – Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9 d.v. and 9f.

2. The changes made in this issue paper regarding the accounting treatment of the additional minimum pension liability will create a nonsubstantive change to SSAP No. 72—Surplus and Quasi-reorganizations. Unassigned funds (surplus) will include changes in the additional minimum pension liability.

3. Generally Accepted Accounting Principles (GAAP) guidance for these issues is established in Financial Accounting Standards Board (FASB) Statement No. 87, Employers’ Accounting for Pensions (FAS 87), FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits (FAS 88), FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits (FAS 132), and FASB Statement No. 130, Other Comprehensive Income (FAS 130).

4. The purpose of this issue paper is to establish statutory accounting principles for an employers’ pension obligations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

Defined Benefit Plans

5. A defined benefit plan defines the amount of the pension benefit that will be provided to the plan participant at retirement or termination. For such benefit plans, reporting entities shall adopt FAS 87 with modifications to exclude non-vested employees and to account for the additional minimum pension liability. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan are recognized as a component of the net periodic pension cost in the period the employee becomes vested. Any intangible asset or prepaid expense, other than the intangible asset associated with the transition obligation recorded as of January 1, 2001, resulting from adoption of the provisions of this issue paper shall be considered a nonadmitted asset, as such an asset cannot be readily converted to cash to satisfy policyholder obligations. This is consistent with the definition of assets and nonadmitted assets set forth in SSAP No. 4—Assets and Nonadmitted Assets.

6. If the accumulated benefit obligation exceeds the fair value of plan assets, the reporting entity shall recognize a liability (including unfunded accrued pension cost) that is at least equal to the unfunded
accumulated benefit obligation. Recognition of an additional minimum liability is required if an unfunded accumulated benefit obligation exists and (a) a prepaid pension cost asset has been recognized as a nonadmitted asset, (b) the liability already recognized as unfunded accrued pension cost is less than the unfunded accumulated benefit obligation, or (c) no accrued or prepaid pension cost has been recognized.

7. If an additional minimum liability is recognized an equal amount shall be recognized as an intangible asset, provided that the asset recognized shall not exceed the amount of unrecognized prior service cost (unrecognized prior service cost shall include unamortized incremental liability). If an intangible asset generated by the additional minimum liability is recognized, only that portion in excess of the unamortized incremental liability associated with the transition shall be nonadmitted. If an additional liability required to be recognized exceeds unrecognized prior service cost, the excess (which would represent a net loss not yet recognized as net periodic pension cost) shall be reported as a component of unassigned funds (surplus), net of any tax benefits that result from considering such losses as temporary differences for purposes of applying the provisions of SSAP No. 10—Income Taxes.

8. When a new determination of the amount of additional liability is made, the related intangible asset and the balance accumulated in unassigned funds (surplus) shall be eliminated or adjusted as necessary.

9. If a reporting entity settles or curtails a defined benefit plan, the reporting entity shall immediately recognize all previously unrecognized amounts as discussed below. A settlement is a transaction which is irrevocable and releases the employer from responsibility for the pension obligation by eliminating the risks relative to the obligation and the assets associated with the plan (e.g., making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits or purchasing nonparticipating annuity contracts to cover vested benefits). If a settlement occurs and the net result is a loss, such loss is recognized at the time of the settlement. If the net result is a gain, such gain is not recognized until the proceeds are received by the reporting entity. A curtailment is an event which significantly alters the makeup of the pension plan. If a curtailment occurs, there are generally two components to any gain or loss (e.g., a reduction in the years of service required or the employees covered). Any unrecognized prior service cost shall be recognized as a loss. An increase or decrease in pension benefit obligations due to the curtailment will also result in a gain or loss, and is combined with the prior service cost loss. If the net result of the curtailment is a loss, such loss shall be recognized when it is probable that the curtailment will occur and that the effects can be reasonably estimated. If the net result is a gain, such gain shall not be recognized in earnings until the employees terminate or the plan suspension or amendment is adopted and the proceeds are received by the reporting entity. When such settlement or curtailment gains are recognized, any excess tax surcharges shall also be recognized.

**Defined Contribution Plans**

10. A defined contribution plan defines the amount of the employer's contributions to the plan and its allocation to plan participants. The pension benefit provided to the plan participant at retirement or termination depends on the amount of employer and employee contributions, earnings on plan investments and, in some plans, other participant forfeitures.

11. For defined contribution plans, the reporting entity shall expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses, and shall be nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants beginning at the date the participant initially vests in plan contributions.
12. Certain defined contribution plans may define the employer’s contribution as a percentage of the plan participants’ individual compensation rather than as a specific dollar amount which is allocated among the plan participants. If an employer's contributions to a defined contribution plan are in excess of those required under the plan and required to be allocated to individual participants, such amounts are recorded as a prepaid expense and nonadmitted under statutory accounting principles.

**Disclosures**

13. The following disclosures shall be made for defined benefit pension plans for which the reporting entity is directly liable:

- a. A reconciliation of beginning and ending balances of the benefit obligation showing separately, if applicable, the effects during the period attributable to service cost, interest cost, contributions by plan participants, actuarial gains and losses, foreign currency exchange rate changes, benefits paid, plan amendments, business combinations, divestitures, curtailments, settlements, and special termination benefits;

- b. The amount of the pension obligation for non-vested employees as of the most recent actuarial valuation date;

- c. A reconciliation of beginning and ending balances of the fair value of plan assets showing separately, if applicable, the effects during the period attributable to actual return on plan assets, foreign currency exchange rate changes, contributions by the reporting entity, contributions by plan participants, benefits paid, business combinations, divestitures, and settlements;

- d. The funded status of the plan, the amounts not recognized in the statement of financial position, and the amounts recognized in the statement of financial position, including:
  
  - i. The amount of any unamortized prior service cost;
  
  - ii. The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value);
  
  - iii. The amount of any remaining unamortized, unrecognized net obligation or net asset existing at the initial date of application of this statement;
  
  - iv. The net pension or other postretirement benefit prepaid assets or accrued liabilities; and
  
  - v. Any intangible asset;

- e. The amount of net periodic benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized incremental liability or incremental asset (see paragraph 20), the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment;

- f. The amount included in unassigned funds (surplus) for the period arising from a change in the additional minimum pension liability recognized pursuant to paragraph 7;

- g. On a weighted-average basis, the following assumptions used in the accounting for the plan: assumed discount rate, rate of compensation increase (for pay-related plans), and expected long-term rate of return on plan assets;
h. If applicable, the amounts and types of securities of the reporting entity and related parties included in plan assets, the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the reporting entity or related parties, and any significant transactions between the reporting entity or related parties and the plan during the period;

i. If applicable, any alternative amortization method used to amortize prior service amounts or unrecognized net gains and losses pursuant to paragraphs 26 and 33 of FAS 87;

j. If applicable, any substantive commitment, such as past practice or a history of regular benefit increases, used as the basis for accounting for the benefit obligation;

k. If applicable, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event; and

l. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures required by this statement.

Amounts related to the reporting entity’s results of operations shall be disclosed for each period for which an income statement is presented. Amounts related to the reporting entity’s statement of financial position shall be disclosed for each balance sheet presented.

14. The reporting entity shall disclose the amount of cost recognized for defined contribution pension plans during the period separately from the amount of cost recognized for defined benefit plans. The disclosures shall include a description of the nature and effect of any significant changes during the period affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

15. The reporting entity shall disclose the amount of contributions to multiemployer plans during the period. The reporting entity may disclose total contributions to multiemployer plans without disaggregating the amounts attributable to pensions and other postretirement benefits. The disclosures shall include a description of the nature and effect of any changes affecting comparability, such as a change in the rate of employer contributions, a business combination, or a divestiture.

16. Refer to the preamble for further discussion regarding disclosure requirements.

Consolidated/Holding Company Plans

17. The employees of many reporting entities are members of a plan sponsored by a parent company or holding company. A reporting entity who participates in these plans and is not directly liable for obligations under the plan shall recognize pension expense equal to its allocation from the holding company or parent company of the required contribution to the plan for the period. A liability shall be established for any such contributions due and unpaid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for obligations under the plan, then the requirements outlined above in paragraphs 5 to 13 and 20 to 24 of this issue paper shall be applied.

DISCUSSION

18. The conclusions in paragraphs 5 to 13 and 20 to 24 adopt FAS 87, FAS 88, and FAS 132 with certain modifications. Those modifications and additional information from nullified interpretations are listed below:
a. Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts;

b. A liability for ancillary benefits (primarily death and disability benefits) shall be accrued prior to the triggering event of these benefits for purposes of Projected Benefit Obligation (PBO) and Service Cost (SC) in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

c. A liability for protected, nonvested benefits shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

d. A liability for nonvested, nonqualified benefits prior to retirement or when there is no longer a substantial risk of forfeiture, shall be accrued for purposes of PBO and SC in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard);

e. Entities shall perform actuarial analysis consistent with the three month guideline contained within FAS 87;

f. A reporting entity that utilizes an actuarial valuation as of a date prior to the financial statement date to measure plan assets and obligations, and determines that an additional minimum liability is required to be established in accordance with paragraph 37 of FAS 87, and if the reporting entity contributes amounts to the plan to fund that additional minimum liability prior to the financial statement date, such amount funded may be used to reduce the additional minimum liability recognized in the reporting entity’s financial statements;

g. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions (OPEB) liability generated by one plan against the prepaid asset of another plan;

h. Reporting entities may downsize their operations and in doing so, often offer severance pay and other benefits to displaced workers. Costs associated with downsizing shall be recorded as an expense in the financial statements;

i. The prepaid asset which results from an excess of the fair value of plan assets over the pension obligation shall be recorded as a nonadmitted asset;

j. Any intangible asset offsetting the minimum pension liability (excluding the unamortized incremental liability associated with transition) shall be nonadmitted and charged to surplus;

k. Any additional minimum liability in excess of unrecognized prior service cost that is reported as a component of unassigned funds (surplus), shall be classified as an aggregate write-in for gains and losses in surplus;

l. As of January 1, 2001 the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods;

m. Paragraphs 36 through 38 of FAS 87 are adopted with modifications described in paragraph 7 of this issue paper;
n. A net gain (net of excess tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity;

o. The reduced disclosure requirements for nonpublic entities described in paragraph 8 of FAS 132 are rejected. All reporting entities shall follow the disclosure requirements included in paragraph 5 of FAS 132;

p. For the disclosures relating to the initial date of application in paragraph 5 of FAS 132, January 1, 2001 shall be considered the initial date of application; and

q. Pension disclosures relating to other comprehensive income in paragraph 5 of FAS 132 shall be made for unassigned funds (surplus) on a statutory basis.

19. This issue paper also adopts FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan, FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan, FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits, and FASB Emerging Issues Task Force No 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination.

Effective Date and Transition

20. As of January 1, 2001, the transition obligation or asset shall be determined as the difference between the vested projected benefit obligation and the fair value of plan assets. If prior to the effective date of January 1, 2001, the reporting entity has adopted FAS 87 for statutory accounting purposes, the transition obligation or asset calculated above shall be compared to those amounts previously recorded under FAS 87. The difference between these amounts represents an incremental asset or liability. If the reporting entity has not previously adopted FAS 87 for statutory accounting purposes, the entire transition asset or obligation represents the incremental asset or liability.

21. As of January 1, 2001, if the reporting entity calculates an incremental liability, this liability shall be recognized according to one of the two following methods:

   a. The reporting entity may elect to record the entire incremental liability as a direct charge to surplus;

   b. Alternatively, the reporting entity may elect to amortize the incremental liability as a component of net periodic pension cost over a period not to exceed 20 years.

22. As of January 1, 2001, if the reporting entity calculates an incremental asset, this asset shall be recognized according to one of the two following methods:

   a. The reporting entity may elect to record the entire incremental asset as a direct credit to surplus;

   b. Alternatively, the reporting entity may elect to accrue the incremental asset as a component of net periodic pension cost in an amount each period such that total net periodic pension cost may be reduced to an amount not less than zero (i.e., the accrual of the incremental asset may be used to offset current period net periodic pension cost).

23. An incremental asset resulting from a transition obligation that is less than an amount previously recorded under FAS 87 shall first reduce the recorded liability. Any remaining incremental asset shall be recorded as nonadmitted.
This issue paper is effective for years ending on or after, December 31, 2003. SSAP No. 8 applies to the calculation of the transition obligation in accordance with the adoption of FAS 87 for periods prior to the adoption of this statement. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors. For reporting entities that expensed the additional minimum pension liability through income prior to January 1, 2004 under SSAP No. 8, if the additional minimum pension liability subsequently decreases because of factors such as asset value recovery, the reversal of the expense shall be through unassigned funds (surplus). Restatement of previously expensed additional minimum liability amounts through the income statement is not permitted.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
25. The following is excerpted from Interpretation 02-18

The working group reached a consensus to require reporting entities to recognize the entire minimum pension liability in the financial statement. Further, any intangible asset offsetting the minimum pension liability shall be nonadmitted and charged to surplus.

26. See Issue Paper No. 8 for additional statutory references

Generally Accepted Accounting Principles
27. The following is excerpted from FASB Statement No. 130, Other Comprehensive Income (FAS 130):

10. This Statement uses the term comprehensive income to describe the total of all components of comprehensive income, including net income. This Statement uses the term other comprehensive income to refer to revenues, expenses, gains, and losses that under generally accepted accounting principles are included in comprehensive income but excluded from net income. This Statement does not require that an enterprise use the terms comprehensive income or other comprehensive income in its financial statements, even though those terms are used throughout this Statement.

FAS130, Footnote 4—This Statement uses the term net income to describe a measure of financial performance resulting from the aggregation of revenues, expenses, gains, and losses that are not items of other comprehensive income as identified in this Statement. A variety of other terms such as net earnings or earnings may be used to describe that measure.

FAS130, Footnote 5—Paragraph 40 of Concepts Statement 5 states that “just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and other equivalent terms will be used in future financial statements as names for comprehensive income.”

28. See Issue Paper No. 8 for additional GAAP references

OTHER SOURCES OF INFORMATION
29. See Issue Paper No. 8 for Other Sources of Information

RELEVANT LITERATURE

Statutory Accounting
- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- SSAP No. 8—Pensions
- Issue Paper No. 3 - Accounting Changes
- Issue Paper No. 4 - Definition of Assets and Nonadmitted Assets
- Issue Paper No. 5 - Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 8 – Accounting for Pensions
- Minutes from the June 23, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 15, 1987 meeting of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the June 12, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Minutes from the September 8, 1986 meeting of the Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies
- NAIC Annual Statement Instructions for Life and Accident and Health Insurance Companies
- NAIC Annual Statement Instructions for Property and Casualty Insurance Companies
- Employers’ Accounting for Postretirement Benefits Other Than Pensions - Field Test of the Statutory Proposal - prepared by the Codification Advisory Group, September 20, 1992
- INT 02-18: Accounting for the Intangible Asset as Described in SSAP No. 8 Paragraph 9 d.v. and 9 f.
- INT 01-16 – Measurement Date for SSAP No. 8 Actuarial Valuations
- INT 01-17 – Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans
- INT 99-24 – Accounting for Restructuring Charges
- INT 99-26 – Offsetting Pension Assets and Liabilities

Generally Accepted Accounting Principles
- FASB Statement No. 87, Employers’ Accounting for Pensions
- FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits
- FASB Statement No. 132, Employers’ Disclosures about Pensions and Other Postretirement Benefits
- FASB Emerging Issues Task Force No. 88-1, Determination of Vested Benefits Obligation for a Defined Benefit Pension Plan
- FASB Emerging Issues Task Force No. 90-3, Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan- FASB Emerging Issues Task Force No. 91-7, Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits
- FASB Emerging Issues Task Force No. 96-5, Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination
- FASB Statement No. 130, Other Comprehensive Income

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22, General Expenses and Taxes, Licenses and Fees
- Draft discussion material from previous Property/Casualty codification projects - Chapter on Non-Claim Operating Expenses

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Appendix F
Policy Statements

Introduction

The Policy Statements contained within Appendix F are not included within the Statutory Hierarchy and thus should not be considered accounting guidance. As such, the Policy Statements are included for informational purposes only.

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Statutory accounting principles (SAP) provide the basis for insurers to prepare financial statements to be filed with and utilized by state insurance departments for financial regulation purposes. Accuracy and completeness of such filings are critical to meaningful solvency monitoring. Accordingly, maintenance of SAP guidance for changes in the industry and changes in regulatory concerns is vital to preserving the usefulness of SAP financial statements.

The promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues Working Group (EAIWG) will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Composition of the Working Groups

The chair of the Task Force shall determine membership on both working groups subject to approval by the Financial Condition (E) Committee. The groups shall be limited in size to no more that 13 members and will include representation from the four zones of the NAIC. Membership shall be vested in the state (until such time as the membership may be changed) but continuity of individuals, to the extent possible, is extremely desirable.

Development of New SSAPs

New SSAPs will be developed from time-to-time that: 1) address issues not covered by existing SAP guidance; 2) amend existing SSAPs; or, 3) supersede existing SSAPs. The decision to undertake development of a new SSAP will rest with the SAPWG subject to approval of the Task Force. The SAPWG will report to the Task Force on its agenda and progress, if any, at each quarterly National Meeting of the NAIC.

As new Statements of Statutory Accounting Principles (SSAP) are developed, it is essential to review and, if necessary, update the status of Interpretations of the Emerging Accounting Issues Working Group related to the SSAPs that are being replaced and/or the new SSAP being developed.

The following list of options is available to the SAPWG when an SSAP with existing interpretations is replaced:

a. **Interpretation of the new SSAP** - If the SAPWG group would like to maintain the Interpretation, the new SSAP can be added to the list of statements interpreted by the Interpretation. In addition, the status section of the new SSAP will list the Interpretation number next to the heading “Interpreted by.”

b. **Nullification** - When an Interpretation is nullified by a subsequent SSAP or superseded by another Interpretation, the Interpretation is deemed no longer technically helpful and is shaded. The reason for the change is noted beneath the title of the Interpretation. The status section of the Interpretation describes the impact of the new guidance and the affect on the Interpretation (for example, nullifies, incorporated in the new SSAP with paragraph reference or affects that Issue).
Appendix F

c. **Incorporation** - When an Interpretation is incorporated into a new SSAP the working group can choose from the following two options:

i. If the Interpretation only interprets one SSAP, then the Interpretation is listed as being nullified under the “affects” section and Interpretation is not referenced under the “interpreted by” section of the status page of the SSAP.

ii. If the Interpretation references additional SSAPs, and the working group intends to maintain the guidance, the Interpretation is unchanged (no nullification). The new SSAP (Summary of Issue section) reflects that the Interpretation issue has been incorporated into the new statement.

Research and drafting on new SSAPs will be performed by the NAIC staff under the direction and supervision of the SAPWG which may enlist the assistance of interested parties with requisite technical expertise as needed or desired. The first step in developing new SSAPs will usually be the drafting of an Issue Paper (IP), which will contain summary conclusion, discussion and relevant literature sections. Public comment will be solicited on the IPs, and at least one public hearing will be held on an IP before it is converted to a SSAP. Upon approval by the SAPWG, all proposed SSAPs will be exposed for public comment for a period commensurate with the length of the draft and the complexities of the issue. Adoption of SSAPs by the SAPWG, after hearing and any further amendments, may be by simple majority. All SSAPs must be on the agenda for at least one public hearing before presentation to the Task Force for consideration. Adoption by the Task Force, its parent and the NAIC membership shall be governed by the NAIC bylaws.

If accounting guidance, reserving standards, asset valuation standards, or any other standards or rules affecting accounting practices and procedures are developed by other NAIC working groups, task forces, subcommittees, or committees, such guidance, standards or rules must be reviewed by the SAPWG and converted to an SSAP or a revised appendix. In cases where such guidance has already been subjected to substantial due process (e.g., public comment periods or public hearings), the SAPWG may recommend to the Task Force that either the IP or SSAP comment periods may be shortened or eliminated or the hearings may be eliminated.

**Procedures for Emerging Accounting Issues Working Group**

The EAIWG will be responsible for responding to SAP questions that generally relate to application, interpretation and clarification. In no event shall a consensus opinion of the EAIWG amend, supersede or otherwise conflict with existing, effective SSAPs. In no event will a consensus be less than six out of quorum of nine members of the EAIWG; a consensus will also be determined by a vote of seven of 10 members, eight of 11 or 12 members, and nine of 13 members. In the rare event that an opinion of the EAIWG would create SAP not addressed by SSAPs, concurrence of SAPWG (as determined by a majority vote) will be necessary before the guidance becomes effective.

The EAIWG’s agenda will be established at the discretion of the chair, subject to approval of the Task Force. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The guidance contained in the consensus opinions of the group will become effective upon publication unless otherwise stated in the opinion. Consensus opinions can be overturned, amended or deferred only by a two-thirds majority of the Task Force.
NAIC Policy Statement on
Comments to GAAP Exposure Drafts

As expressed in the Statement of Concepts, Statutory Accounting Principles (SAP) utilizes the framework established by Generally Accepted Accounting Principles (GAAP). The NAIC’s guidance on SAP (defined in the Accounting Practices and Procedures Manual) is comprehensive for those principles that differ from GAAP based on the concepts of statutory accounting. Those GAAP Pronouncements that are not applicable to insurance companies will not be adopted by the NAIC. For GAAP Pronouncements that do not differ from SAP, the NAIC may specifically adopt those GAAP Pronouncements to be included in statutory accounting. GAAP Pronouncements do not become part of SAP until and unless adopted by the NAIC. Future SAP Pronouncements will specifically identify any GAAP Pronouncements that are to be included in SAP whether in whole, in part, or with modification as well as any GAAP Pronouncements that are rejected. Future GAAP Pronouncements, which SAP has not yet addressed, shall not be considered as providing authoritative statutory guidance.

As illustrated by the previous paragraph, the NAIC believes it is important to comment on GAAP exposure drafts that will affect SAP before such guidance is finalized. Exposing potentially contentious issues to the applicable GAAP bodies before completion will create a more efficient and effective maintenance process for the Statutory Accounting Principles Working Group (SAPWG). In addition, this also allows the NAIC to be proactive to GAAP rather than reactive under the current system.

Comments on exposed GAAP Pronouncements affecting financial accounting and reporting will be developed at the discretion of the SAPWG chair. After the comment letter has been agreed to by the SAPWG, the chair of the Accounting Practices and Procedures Task Force and the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties; however, FASB/American Institute of Certified Public Accountants (AICPA) deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent task force and Committee may override such decision at any time.

Comments on exposed Pronouncements promulgated by the AICPA will be developed at the discretion of the NAIC/AICPA Working Group chair. The chair may defer comment to the SAPWG if the pronouncement affects financial accounting guidance. After the comment letter has been agreed to by the NAIC/AICPA Working Group, the chair of the Financial Condition (E) Committee must review and approve the letter before it is sent to the applicable GAAP body. Every reasonable attempt will be made to provide an adequate comment period to interested parties, however FASB/AICPA deadlines may inhibit exposure in every instance. The chair will consider factors such as comment deadline and level of controversy surrounding the issue. The chair of the parent Committee may override such decision at any time.

These comment letters may be considered during the maintenance of finalized GAAP Pronouncements by the SAPWG (as defined in the NAIC Policy Statement on Maintenance of Statutory Accounting Principles). Nevertheless, these letters will not bind the SAPWG to its tentative position during its deliberation to adopt, modify or reject the final GAAP guidance.
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The purpose of the following Policy Statement is to document the Statutory Accounting Principles Working Group (SAPWG) maintenance agenda process.

As acknowledged in the NAIC Policy Statement on Maintenance of Statutory Accounting Principles, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The SAPWG shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The Emerging Accounting Issues Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the SAPWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, or from interested parties. Also, if any guidance within the Generally Accepted Accounting Principles (GAAP) Hierarchy (see § IV of the Preamble to the Accounting Practices and Procedures Manual) is added or revised, those changes must be considered by the SAPWG. In order for an issue to be placed on the Pending List, the recommending party must complete a Statutory Accounting Principles Maintenance Agenda Submission Form (Form A) and submit it to the NAIC SAPWG support staff no later than 20 business days prior to the next scheduled SAPWG meeting. The NAIC staff will prepare a submission form for all GAAP pronouncements that have not been previously addressed by the SAPWG. NAIC staff will update the Pending List before each National Meeting and will notify the recommending party of such action. If the SAPWG does not wish to address the issue (e.g.; issue deemed not applicable to statutory accounting) or rejects the position presented, then the item is moved to the Rejected Report. Should the SAPWG choose to address an issue, it is moved to either the Substantive or Nonsubstantive Listings.

The Substantive Listing are items that require a new issue paper and SSAP to address the issue. Once items are placed on this listing, they are prioritized and the formal maintenance policy is followed (see NAIC Policy Statement on Maintenance of Statutory Accounting Principles). The SAPWG will utilize the NAIC website for exposure of substantive items. The Nonsubstantive Listing contains items that are considered editorial or technical in nature and therefore a new SSAP will not be developed. In other words, a revision to a SSAP for these items will not be deemed to modify its conclusion or original intent. The Rejected Report identifies all the items that were proposed to the SAPWG and rejected or deemed not applicable to statutory accounting. The Active Report identifies items that are in the process of completion. The Active Report is prioritized and shows the status of issue papers and SSAPs. The Disposition Report captures the conclusions of the SAPWG.

It should be noted that this Policy Statement addresses the process and the flow of information. The timing is left to the discretion of the SAPWG. For instance, an item can move from the pending list to the substantive disposition report in one, two or three National Meetings.

The NAIC staff will maintain a current Maintenance Agenda on the NAIC website at www.naic.org. Attachment A to this Policy Statement includes a flowchart depicting the flow of information. Attachment B includes a blank Form A. Attachment C is an example the document that will be attached to all exposed documents and will serve as the notice of public hearing and request for written comments.
Statutory Accounting Principles Maintenance Process
Illustration of Flow of Information

LEVEL 1

- GAAP Status Report
- Pending List
- All Other Sources

LEVEL 2

- Substantive List
- Rejected Report
- Nonsubstantive List

LEVEL 3

- Disposition Report
- Active Report
- Active Report
- Disposition Report
Issue: ______________________________________________________________________________________

Check (applicable entity):

- Correction of existing SSAP
- New Issue or SSAP

P/C          Life          Health

*Description of Issue: ______________________________________________________________________________________

*Existing Authoritative Literature: ______________________________________________________________________________________

*Activity to Date (issues previously addressed by SAPWG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

____________________________________________________________________________________

*Information or issues (included in Description of Issue) not previously contemplated by the SAPWG:

____________________________________________________________________________________

Recommended Conclusion or Future Action on Issue: ______________________________________________________________________________________

Recommending Party:

(Organization) ______________________________________________________________________________________

(Person Submitting, Title) ______________________________________________________________________________________

(Address, City, State, ZIP) ______________________________________________________________________________________

(Phone and E-mail Address) ______________________________________________________________________________________

(Date Submitted) ______________________________________________________________________________________

* Indicates required information before NAIC staff will accept form as a final document.
Notice of Public Hearing and Request for Written Comments

Hearing Date: __________________ Location: _________________
Deadline for Written Notice of Intent to speak: Deadline for Receipt of Written Comments:

Basis for hearings. The Statutory Accounting Principles Working Group (SAPWG) will hold a public hearing to obtain information from and views of interested individuals and organizations about the standards proposed in this Exposure Draft. The SAPWG will conduct the hearing in accordance with the National Association of Insurance Commissioners (NAIC) policy statement on open meetings. An individual or organization desiring to speak must notify the NAIC in writing by . Speakers will be notified as to the date, location, and other details of the hearings.

Oral presentation requirements. The intended speaker must submit a position paper, a detailed outline of a proposed presentation or comment letter addressing the standards proposed in the Exposure Draft by __________. Individuals or organizations whose submission is not received by that date will only be granted permission to present at the discretion of the SAPWG chair. All submissions should be addressed to the NAIC staff at the address listed below. Comments can also be submitted by electronic mail to __________@naic.org.

Format of the hearings. Speakers will be allotted up to 10 minutes for their presentations to be followed by a period for answering questions from the SAPWG. Speakers should use their allotted time to provide information in addition to their already submitted written comments as those comments will have been read and analyzed by the SAPWG. Those submissions will be included in the public record and will be available at the hearings for inspection.

Copies. Exposure Drafts can be obtained on the Internet at the NAIC Home Page (http://www.naic.org). The documents can be downloaded using Microsoft Word or WordPerfect.

Written comments. Participation at a public hearing is not a prerequisite to submitting written comments on this Exposure Draft. Written comments are given the same consideration as public hearing testimony.

The Statutory Accounting Principles Statement of Concepts was adopted by the Accounting Practices & Procedures (EX4) Task Force on September 20, 1994, in order to provide a foundation for the evaluation of alternative accounting treatments. All issues considered by the SAPWG will be evaluated in conjunction with the objectives of statutory reporting and the concepts set forth in the Statutory Accounting Principles Statement of Concepts. Whenever possible, establish a relationship between your comments and the principles defining statutory accounting.

The exposure period is not meant to measure support for, or opposition to, a particular accounting treatment but rather to accumulate an analysis of the issues from other perspectives and persuasive comments supporting them. Therefore, form letters and objections without valid support for their conclusions are not helpful in the deliberations of the working group. Comments should not simply register your agreement or disagreement without a detailed explanation, a description of the impact of the proposed guidelines, or possible alternative recommendations for accomplishing the regulatory objective.

Any individual or organization may send written comments to __________ at the address listed below, no later than ________. Comments can also be submitted by electronic mail to ________@naic.org. Electronic submission followed by signed hardcopy is preferred. After they have been reviewed by the SAPWG, these letters will be available for public inspection and may be obtained by contacting the NAIC Insurance Products and Services Division (816) 783-8300.

National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604 (816) 842-3600
NAIC Policy Statement on Emerging Accounting
Issues Agenda Process

The purpose of the following Policy Statement is to document the Emerging Accounting Issues Working Group (EAIWG) agenda process.

As acknowledged in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles Working Group shall have the exclusive responsibility of developing and proposing new Statements of Statutory Accounting Principles (SSAPs). The EAIWG will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

Information and issues can be presented to the EAIWG in a variety of ways. Issues can be recommended or forwarded from other NAIC working groups or task forces, from interested parties or from the NAIC staff. In order for an issue to be placed on the Agenda, the recommending party must complete an Emerging Accounting Issues Working Group Agenda Submission Form (Form B) and submit it to the NAIC staff no later than 20 business days prior to the next scheduled EAIWG meeting. NAIC staff will update the Agenda before each National Meeting and will notify the recommending party of such action. Every issue taken up by the EAIWG must be discussed at no less than two open meetings with opportunity for interested parties to present comments. The NAIC website will be utilized for such exposures. The website will maintain the applicable Form B and the tentative consensus opinions. Final consensus opinions will be published annually in Appendix B to the *Accounting Practices and Procedures Manual*. The guidance contained in the consensus opinions of the EAIWG will become effective upon publication unless otherwise stated in the opinion.

Exhibit A includes a blank Form B.
Emerging Accounting Issues Working Group
Agenda Submission Form
Form B

Issue:

*Description of Transaction/Event/Issue:

*Accounting Issues:

*Authoritative Literature (exerpt applicable references):

*Activity to Date (issues previously addressed by Statutory Accounting Principles WG, Emerging Accounting Issues WG, SEC, FASB, other State Departments of Insurance or other NAIC groups):

*Recommended Conclusion or Future Action on Issue:

+NAIC Staff Recommendation:

Recommending Party:

(Organization)

(Person Submitting, Title)

(Address, City, State, ZIP)

(Phone and E-mail Address)

+NAIC Staff Review Completed by:

(Date Submitted)

* Indicates required information before NAIC staff will accept form as a final document
+ NAIC Staff will complete before presentation to the EAIWG
The purpose of the following Policy Statement is to document the process and procedure for identifying the impact of Statements of Statutory Accounting Principles (SSAP) on NAIC publications.

As referenced in the *NAIC Policy Statement on Maintenance of Statutory Accounting Principles*, the promulgation of new SAP guidance by the NAIC ultimately requires action of the entire membership. Responsibility for proposing new SAP will be delegated through the NAIC committee structure to the Accounting Practices and Procedures Task Force (Task Force). The Task Force will employ two working groups with distinctly different functions to carry out the charge of maintaining SAP. The Statutory Accounting Principles Working Group (SAPWG) shall have the exclusive responsibility of developing and proposing new SSAPs. The Emerging Accounting Issues Working Group will respond to questions of application, interpretation, and clarification that are generally much narrower in scope than development of a new SSAP.

An SSAP can affect the various NAIC publications in many different ways. New accounting practices or procedures may result in new disclosures and reporting requirements (affecting Annual Statement Blank and Instructions), modified analysis techniques (affecting RBC formula or IRIS ratios), or new examination procedures (affecting Examiners Handbook).

The SAPWG shall evaluate the impact that newly adopted SSAPs will have on other NAIC publications. To that end, the SAPWG will complete a SSAP Impact on NAIC Publications form after adoption of every SSAP. This form will be used to evaluate the impact of the SSAP, and to recommend a modification as the SAPWG deems appropriate. The SAPWG may seek the assistance of NAIC staff or interested parties in drafting specific language for the affected publication.

After completion of the form, it will be forwarded with a recommendation to the affected working group or task force. The NAIC staff will update the SAPWG as to the progress of the recommendation.

Exhibit A includes a blank SSAP Impact on NAIC Publications form.
SSAP Impact on NAIC Publications Form

SSAP No. and Title:

Affected NAIC Publication(s) (check):

- Accreditation Standards  - IRIS Ratio Results
- Actuarial Opinion  - Model Laws, Regulations and Guidelines
- Annual Statement Blank  - RBC Formula
- Annual Statement Instructions  - SVO Purposes & Procedures Manual
- Financial Analysis Handbook  - Other: ___________________
- Financial Condition Examiners Handbook

Background and Description of SSAP:

Issues Affecting NAIC Publication(s)

Specific Recommendation or Future Action on Issue (attached separate sheet if necessary):

Recommending Party:

Statutory Accounting Principles Working Group

(Chair)

(Date Adopted by SAPWG)
NAIC Policy Statement on Coordination of the Accounting Practices and Procedures Manual and the Annual Statement Blank

The purpose of the codification of statutory accounting principles (SAP) project was to produce a comprehensive guide to SAP for use by insurance departments, insurers, and auditors. Statutory accounting principles, as they existed prior to codification did not always provide a consistent and comprehensive basis of accounting and reporting. Insurance companies were sometimes uncertain about what rules to follow and regulators were sometimes unfamiliar with the accounting rules followed by insurers in other states. This was due in part to the fact that prior to codification, accounting guidance could be found in the NAIC Accounting Manual, annual Statement Instructions, Examiners Handbook, and various states’ laws and regulations. As a result, insurers’ financial statements were not prepared on a comparable basis. Now that accounting requirements have been more rigidly stipulated by the NAIC, it is imperative that the accounting requirements and the reporting and disclosure requirements remain synchronized. This is an excellent opportunity to create a system of parallel requirements. This effort has already been recognized by the NAIC/AICPA working group. In 1999, the working group modified the Model Regulation Requiring Annual Audited Financial Reports to require the following for audited financial statements:

Notes to financial statements. These notes shall be those required by the appropriate NAIC Annual Statement Instructions and the NAIC Accounting Practices and Procedures Manual. The notes shall include a reconciliation of differences, if any, between the audited statutory financial statements and the annual statement filed pursuant to Section [insert applicable section] of the [insert state] insurance law with a written description of the nature of these differences.

As stated in the model regulation, the NAIC/AICPA working group has an expectation that the requirements of the Annual Statement Instructions and the Accounting Practices and Procedures Manual will be identical in all pertinent parts that are subject to audit. There is no reason to create a different set of audit requirements in the Annual Statement Instructions when a complete and comprehensive guide to statutory accounting exists. However, it must be noted that the Statements of Statutory Accounting Principles (SSAPs) are not intended to prescribe the specific format of the detailed financial statements.

The scope of this Policy Statement is defined as follows:

Any change to the Annual Statement core financials (balance sheet, income statement, cash flow and notes to the financial statements) must reviewed by the Statutory Accounting Principles Working Group to determine whether it conflicts with the disclosure requirements of the SSAPs.

The scope is defined in broad terms because it is very difficult to specify what constitutes a conflict with the SSAPs. For example, the renumbering of the assets page does not conflict because there is not a SSAP that prescribes the order of asset presentation. Contrast this with a seemingly innocuous proposal to modify column 23 of Schedule P - Part 1 (salvage and subrogation anticipated) which would create a disclosure conflict with SSAP No. 55, paragraph 12.

In order to ascertain that the requirements of the Annual Statement Instructions and Blank are in harmony with the SSAPs (as they relate solely to the core financial statements), the following procedures shall be followed:

1. The Blanks Agenda Item Submission Form will include an interrogatory which will indicate to the Blanks Task Force whether the proposal:
a. Affects the core financial statements  
b. Conflicts with an existing SSAP  
c. Is not currently required by a SSAP  
d. Has been reviewed by the Statutory Accounting Principles Working Group

2. One staff member from the Statutory Accounting Principles Working Group and the Blanks Task Force are charged with verifying the accuracy of the interrogatory proposed in (1) above. After the staff reviews the proposals, they will report their findings back to the applicable groups prior to the October meeting of the Blanks Task Force. If the staff identifies issues that need further exploration or consultation, the chairs of the two groups or certain members from each group will hold a joint meeting before the October meeting.

3. The Blanks Task Force will reject proposals that will delete/modify information contained within the core financial statements that are required by an existing SSAP.

4. The Blanks Task Force will either reject proposals that would require additional audited disclosure or audited information within the core financial statements if that same item is not required by an existing SSAP; or move it outside the core financial statements. The sponsoring party will still have the option of placing this information outside the core financial statements (e.g., general interrogatories or interrogatories to schedules) until the disclosure is included in a SSAP. If the disclosure were added to a SSAP in the future, it could be moved to the Notes to the Financial Statements and subject to audit at that time.

5. The NAIC will maintain a SSAP to Annual Statement cross-reference. This cross-reference will contain two significant features. First, it will list all of the SSAP disclosures and reference them to where in the Annual Statement the disclosure requirement is met. Second, the cross-reference will identify the Annual Statement components that are required by a SSAP. The cross-reference can be used by the Blanks Task Force and interested parties in completing the new Blanks Agenda Item Submission Form Interrogatory.

The procedures included in this Policy Statement represent a significant change in the current process, but can only result in increased coordination between the Accounting Practices and Procedures Task Force and the Blanks Task Force. This coordination can only give rise to more consistent, meaningful guidance to the regulators, companies and auditors.