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MAINTENANCE PROCESS

The Statutory Accounting Principles Working Group maintains codified statutory accounting principles (SAP) by concluding on generally accepted accounting principles (GAAP) or addressing new statutory accounting issues. As items are adopted, updates to the Manual are posted to the password-protected Web site listed below.

Web Site: www.naic.org/committees_e_app_manual_updates.htm

User ID and password for updates to the Manual adopted March 2010 through March 2011:

User ID: CONSERVATISM (enter exactly as presented – case sensitive)
Password: 2011JWRLJ (enter exactly as presented – case sensitive)

Email Notification
Should you wish to be notified by the NAIC via e-mail when the password-protected Web site is updated, visit the Web site listed above and follow the link to sign up for e-mail notification of updates to the statutory accounting Web site. The NAIC will retain the 2010 database; therefore, if you were receiving notifications via e-mail in 2010, there is no need to resubmit your request in 2011.

Password for updates adopted June 2011 through March 2012 requires purchase of 2012 Manual:


Ordering Information: You may pre-purchase the March 2012 Accounting Practices and Procedures Manual by contacting an NAIC representative at 816.783.8300, http://www.naic.org/store_home.htm or e-mail at prodserv@naic.org. The March 2012 Accounting Practices and Procedures Manual will be delivered in two parts, first the User ID and Password required to obtain access to the updates Web site, and then the Manual in March 2012. Please contact an NAIC representative as indicated above with any questions on this process.

DEDICATION

This publication is dedicated to Norris Clark, California Department of Insurance (retired), Chair of the Codification of Statutory Accounting Principles Working Group, and its successors, the Statutory Accounting Principles and Emerging Accounting Issues Working Groups from September 1994 through July 2004.

Your dedication, leadership, intelligence and passion were the driving forces behind the creation of the comprehensive statutory accounting and financial reporting model presented in this publication. Your contributions throughout the years are appreciated and will not be forgotten.

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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

Volume II:
- Appendix C – Actuarial Guidelines
- Appendix D – GAAP Cross-Reference to SAP
- Appendix E – Issue Papers 1 to 71

Volume III:
- Appendix E – Issue Papers 72 to 144
- Appendix F – Policy Statements
- Appendix G – Implementation Guide for the Model Audit Rule
- Appendix H – Superseded SSAPs and Nullified Interpretations

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 2010 version of the Accounting Practices and Procedures Manual to create the As of March 2011 version. This is divided into substantive revisions to statutory accounting principles, nonsubstantive revisions to statutory accounting principles, and revisions to the appendices included in the Manual. This is a key resource for users who are looking to identify changes from the prior edition.

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 authoritative statutory 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 Web site to keep abreast of substantive and nonsubstantive changes to the SSAPs. Superseded SSAPs are no longer authoritative and are included in Appendix H of this Manual.
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** – A useful tool for tracking 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 which provides 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 2010 due to the fact that the Manual is published annually. Readers may use the NAIC Web site, as indicated on the inside front cover of the Manual, to keep abreast of recently issued INTs. Nullified INTs are also noted.

**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 2010. Once an INT is finalized, the related SSAP will contain reference to the applicable INT. Interpretations that have been nullified are included in Appendix H of this Manual.

**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 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. This listing includes GAAP pronouncements issued through December 2010. 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 2010. 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.

**Appendix G – Implementation Guide for Model Audit Rule:**
This section includes the NAIC Implementation Guide for the Model Audit Law. This section is for informational purposes. The Implementation Guide should not be viewed as a requirement of complying with the *Accounting Practices and Procedures Manual*.

**Appendix H – Completely Superseded SSAPs and Nullified Interpretations**
In October 2010, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove 100% superseded SSAPs and nullified interpretations (INTs) from Volume I of the Manual and include these items within a new Appendix H in Volume III. Under this approach, only current authoritative guidance is located in Volume I of this Manual, while preserving the historical reference of previous authoritative SSAPs and INTs for accounting purposes.
How to Use 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 provides 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 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 2010. 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 Web site dedicated to providing updates on the latest information impacting statutory accounting. A user must pre-order the As of March 2012 Manual in order to obtain access to the changes occurring during 2011 that are maintained within this password-protected Web site. Once access is granted, a user may enter the Web site and download an Issue Paper, Statement of Statutory Accounting Principles, Appendix or Interpretation that affects this Manual. This Web site 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 Web site. Further details regarding the Web site can be found at www.naic.org.

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How to Use This Manual - 4
... 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>
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<tbody>
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<td>SVO</td>
<td>SVO P&amp;P Manual</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>Statutory Accounting &amp; Reporting Help Line</td>
<td>Annual Statement Reporting &amp; Statutory Accounting</td>
<td>(816) 783-8400</td>
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Summary of Changes to the As of March 2010 Version of the Accounting Practices and Procedures Manual included in the As of March 2011 Version

The following represents a summary of the changes that were made to the As of March 2010 version of the Accounting Practices and Procedures Manual (Manual) to create the As of March 2011 version.

The first section summarizes substantive revisions to the statutory accounting principles. Substantive revisions introduce original or modified accounting principles. Substantive revisions can be reflected in an existing SSAP or a new SSAP. When substantive revisions are made to an existing SSAP, the front of the SSAP identifies the substantive changes and effective date of the substantive revisions. If substantive revisions in an existing SSAP are depicted by underlines (new language) and strikethroughs (removed language) this tracking will not be shown in subsequent manuals. Substantively revised SSAPs and new SSAPs usually refer to a corresponding Issue Paper that will reflect the substantive revisions for historical purposes. If language in an existing SSAP is superseded, the superseded language is shaded, with the reader referred to the new or substantively revised SSAP. Beginning with the As of March 2011 version, SSAPs that are completely superseded and interpretations that are nullified are included in Appendix H.

The second section summarizes the nonsubstantive revisions to the statutory accounting principles. Nonsubstantive changes are characterized as language clarifications which do not modify the original intent of a SSAP, or changes to reference material. Nonsubstantive changes are depicted by underlines (new language) and strikethroughs (removed language) and will not be shown as marked in subsequent manuals.

The third section includes a summary of the appendices in the Manual and the revisions, if any, that have been made to each appendix.

### 1. Substantive Revisions – Statutory Accounting Principles

<table>
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<tr>
<td>SSAP No. 5R</td>
<td>Substantively revised SSAP (SSAP No. 5R) adopts, with modification, FIN 45. The substantive revisions require entities to recognize, at the inception of a guarantee, a liability for the obligations it has undertaken in issuing the guarantee, even if the likelihood of having to make payments under the guarantee is remote.</td>
</tr>
<tr>
<td>SSAP No. 16R</td>
<td>Substantively revised SSAP (SSAP No. 16R) to include guidance regarding software that was previously included in other SSAPs. Also adopts, with modification, ASU 2010-14 as a nonsubstantive change. Revisions are primarily placement revisions, but are substantive as the following SSAPs are superseded: SSAP No. 79—Depreciation of Nonoperating System Software – An Amendment to SSAP No. 16; SSAP No. 81—Software Revenue Recognition; and SSAP No. 82—Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs. As the revisions were mostly a matter of placement within the AP&amp;P Manual, an issue paper was not considered necessary.</td>
</tr>
<tr>
<td>SSAP No. 35R</td>
<td>Substantively revised SSAP (SSAP No. 35R) adopts, with modification, ASC 405-30. The revised SSAP modifies the conditions required before recognizing liabilities for insurance-related assessments. Under the new guidance the liability is not recognized until the event obligating an entity to pay an imposed or probable assessment has occurred. This impacts prospective-premium-based guaranty fund assessments as the event that obligates the entity is the writing of, or becoming obligated to write or renew the premiums on which future assessments are to be based.</td>
</tr>
</tbody>
</table>
Summary of Changes

| SSAP No. 91R | Substantively revised SSAP No. 91R reflects updated guidance for securities lending activities. Substantive revisions alter the accounting and reporting requirements for securities lending transactions. |
| SSAP Nos. 26, 32, and 34 | Adopted revisions to supersede SSAP No. 99 and incorporate the guidance from that SSAP into SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities, SSAP No. 32—Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities) and SSAP No. 34—Investment Income Due and Accrued. Also adopted a nonsubstantive revision to paragraph 24 of SSAP No. 32. Revisions are primarily placement revisions, but are substantive as SSAP No. 99—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment was superseded. As the revisions were mostly a matter of placement within the AP&P Manual, an issue paper was not considered necessary. |

2. Nonsubstantive Revisions – Statutory Accounting Principles

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<td>SSAP No. 9</td>
<td>Revisions reject ASU 2010-09 as not applicable for statutory accounting.</td>
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<td>SSAP No. 10R</td>
<td>Nonsubstantive revisions extended the SSAP No. 10R sunset clause through 2011 and incorporated additional disclosures for tax-planning strategies.</td>
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<td>SSAP No. 17</td>
<td>Revisions reject FAS 86 and EITF 96-14 due to new guidance included in SSAP No. 16R.</td>
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<tr>
<td>SSAP No. 25</td>
<td>Revisions update the disclosure requirements to correspond with SSAP No. 5R.</td>
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<tr>
<td>SSAP No. 43R</td>
<td>Clarified AVR and IMR guidance in SSAP No. 43R to mirror the intent communicated in the SSAP No. 43R Question and Answer Implementation Guide.</td>
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<tr>
<td>SSAP No. 43R</td>
<td>Revisions clarify the definitions of loan-backed and structured securities.</td>
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<td>SSAP Nos. 51, 52 &amp; 61</td>
<td>Revisions expand the disclosure revisions for annuity actuarial reserves and deposit liabilities by withdrawal characteristics.</td>
</tr>
<tr>
<td>SSAP No. 52</td>
<td>Revisions incorporate an annual statement disclosure on retained assets.</td>
</tr>
<tr>
<td>SSAP No. 86</td>
<td>Revisions to paragraphs 21(e) and 55 of SSAP No. 86 to mirror GAAP terminology and incorporate guidance adopted from the ASU 2010-08.</td>
</tr>
<tr>
<td>SSAP No. 87</td>
<td>Revisions include deletion of paragraphs 7 and 8 as all guidance related to software is included in SSAP No. 16R and SSAP Nos. 79 and 82 have been superseded.</td>
</tr>
<tr>
<td>SSAP No. 90</td>
<td>Revisions clarify that if any of the criteria listed in paragraph 6 of SSAP No. 90 are met properties occupied by the company are subject to recoverability testing.</td>
</tr>
<tr>
<td>SSAP No. 100</td>
<td>Revisions adopt, with modification, new and revised disclosures from ASU 2010-06. Also includes revisions that 1) eliminate the requirement to differentiate and report fair value measurements on separate recurring and nonrecurring schedules; 2) clarify that the general disclosure requirements in SSAP No. 100 are for those items that are measured and reported at fair value in the statement of financial position; and 3) allow a net presentation of purchases, sales, issuances and settlements within the rollforward illustration “Fair Value Measurements in Level 3 of the Fair Value Hierarchy.”</td>
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### 3. Revisions to the Appendices

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<tr>
<td>Appendix A</td>
<td>This Appendix includes excerpts of NAIC Model Laws. These Appendices are referenced by specific SSAPs and should only be used in context of the Appendix and the SSAP that references it. No revisions have been made to this Appendix.</td>
</tr>
<tr>
<td>Appendix B</td>
<td>This Appendix includes final, authoritative interpretations of the Emerging Accounting Issues Working Group. There were no new interpretations finalized through December 2010. Interpretations 00-23 and 04-18 were nullified and moved to Appendix H. INT 99-00 has been updated with rejected and/or non-applicable FASB EITFs. INTs were updated to reflect updated SSAP guidance including INT 00-02, INT 00-03, INT 01-28, INT 01-29, INT 03-02, INT 04-01, INT 04-02, INT 06-02, and INT 07-01. Completely nullified INTs have been moved to Appendix H.</td>
</tr>
<tr>
<td>Appendix C</td>
<td>Appendix C includes actuarial guidelines developed by the Life and Health Actuarial Task Force. The Appendix to the Actuarial Guidelines has been updated, as well as Actuarial Guidelines XXV and XXXVIII. These revisions have not been “marked” as changes in the appendix.</td>
</tr>
<tr>
<td>Appendix D</td>
<td>This Appendix provides a GAAP cross-reference to statutory accounting. This listing has been updated to reflect the current status of GAAP pronouncements as of December 2010. The presentation of this listing includes the FASB Accounting Standards Codification reference. The FASB Accounting Standards Codification reference does not reflect GAAP guidance adopted for statutory accounting, but simply identifies the revised authoritative GAAP guidance. Revisions to this Appendix have not been “marked” as changes in the appendix.</td>
</tr>
<tr>
<td>Appendix E</td>
<td>This Appendix includes Issue Papers for adopted new SSAPs and substantively revised SSAPs. (Issue Papers are not authoritative.) This Appendix has been updated to reflect nonsubstantive modifications made to Issue Paper No. 99—Nonapplicable GAAP Pronouncements for GAAP guidance rejected as not applicable to statutory accounting through December 2010. This Appendix was also updated to add Issue Paper Nos. 135, 143, and 144 to correspond with substantive revisions to SSAP No. 5R, SSAP No. 35R and SSAP No. 91R, respectively.</td>
</tr>
<tr>
<td>Appendix F</td>
<td>This Appendix includes the NAIC Policy Statements applicable to SAP. No revisions have been made to this Appendix.</td>
</tr>
<tr>
<td>Appendix G</td>
<td>This Appendix includes the NAIC Implementation Guide for the Model Audit Law. This Appendix has been modified to reflect updated guidance on the Management’s Report of Internal Control over Financial Reporting, including revised examples in the appendix.</td>
</tr>
<tr>
<td>Appendix H</td>
<td>This Appendix contains completely superseded SSAPs and nullified INTs for historical reference. Authoritative statutory accounting guidance is located in Volume I.</td>
</tr>
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In October 2010, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove 100% superseded SSAPs and nullified interpretations (IN Ts) from Volume I of the Manual and include these items within a new Appendix H in Volume III. Under this approach, only current authoritative guidance is located in Volume I of this Manual, while preserving the historical reference needed for accounting purposes. If a SSAP or interpretation has been superseded, it is included in Appendix H.

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Appendix B - Interpretations of Emerging Accounting Issues Working Group - Volume I

In 2009, the Emerging Accounting Issues Working Group reached a consensus to incorporate “rejected” and “non-applicable” FASB EITFs that do not provide additional statutory accounting guidance in a listing within a designated interpretation. This interpretation (INT 99-00) includes reference of all FASB EITFs, including those previously included in Appendix B as a statutory accounting interpretation, that were 1) rejected as not applicable to statutory accounting; 2) rejected without providing additional statutory guidance; or 3) rejected on the basis of issues rejected in an SSAP. INT 99-00 will be updated as needed to reference future GAAP interpretations as appropriate.

In October 2010, the Statutory Accounting Principles (E) Working Group adopted a proposal to remove 100% superseded SSAPs and nullified interpretations (INTs) from Volume I of the Manual and include these items within a new Appendix H in Volume III. Under this approach, only current authoritative guidance is located in Volume I of this Manual, while preserving the historical reference needed for accounting purposes. If a SSAP or interpretation has been superseded, it is included in Appendix H.

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ACTUARIAL GUIDELINES

Introduction

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 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, that 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.

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1. The purpose of this guideline (items 2 and 3 below) is to clarify the intent of the Standard Valuation Law.

2. The method of valuation promulgated by the model legislation adopted by the NAIC in December 1976 for the valuation of life insurance policies whose valuation net premiums exceed the actual gross premiums collected is a change in method of reserve calculation and not a change in reserve standards.

3. For policies so valued the maximum permissible valuation interest rate and the applicable mortality basis specified is that in effect at the date of issue of such policies.
RESERVE REQUIREMENTS WITH RESPECT TO INTEREST RATE GUIDELINES ON ACTIVE LIFE FUNDS HELD RELATIVE TO GROUP ANNUITY CONTRACTS

As part of the determination of the aggregate minimum group annuity reserves, a computation must be made of minimum reserves for deposit administration group annuity funds with interest rate guarantees including all such funds pertaining to possible purchase of group annuities whether such funds are held in a separate account or in a general account, whether shown as premiums, advance premiums, auxiliary funds, etc. and whether the liability is shown in Exhibit 8 or elsewhere. In making such computations, the procedure and minimum standards described below shall be applicable for the December 31 calendar year “y” valuation giving recognition to the dates deposits were made. Where appropriate and with the approval of the commissioner, recognition may be given to the extent and time of application of active life funds to purchase annuities, expense assessments against the funds, and excess of purchase price over minimum reserves. In no event shall the reserve be less than the transfer value, if any, of the fund. Approximate methods and averages may be employed with the approval of the commissioner.

To the extent that the application of these valuation procedures and standards would require a company to establish aggregate minimum reserves for group annuities and related funds in excess of reserves which it would not otherwise hold if these valuation procedures and standards did not apply, such company shall set up additional reserve liability shown in its general account or in a separate account, whether shown in Exhibit 8 or elsewhere.

The valuation procedures and standards specified in this guideline shall not be applicable to the extent that the valuation procedures and standards relating to reserves for deposit administration group annuity funds with interest rate guarantees (i.e., group annuity and guaranteed interest contracts) in the amendments to the Standard Valuation Law adopted by the National Association of Insurance Commissioners in December 1980, or in later NAIC amendments, have become applicable in a jurisdiction.

For funds receive:

(1) Prior to calendar year 1976, follow the procedure used at that time.

(2) In calendar year 1976 or later, follow the minimum standards described below:

(a) Contracts having no guaranteed interest rates in excess of 6% on future contributions to be received more than one year subsequent to the valuation date.

The minimum reserve shall be equal to the sum of the minimum reserves for funds attributable to contributions received in each calendar year.

Where $V_y =$ Minimum reserve for funds attributable to contributes received in calendar year $y$.

$$V_y = \frac{[C_y \times (1 + i_{gy})^n]}{(1 + i_{py})^n}$$

$C_y =$ Portion of guaranteed fund attributable to contributions received in calendar year $y$

$i_{gy} =$ Interest rate guaranteed under the contract with respect to funds attributable to contributions received in calendar year $y$.

$i_{py} =$ Lowest of:
(1) The net new money rate credited by the company on group annuity funds attributable to contributions received in calendar year $y$ less .005; or

(2) $i_{gy}$; or

(3) $i_{my}$, where

(i) $i_{my} = $ for calendar years $y + 1$ through $y + 10$, the values shown in the table of values of $i_{my}$ distributed each year by the Central Office of the National Association of Insurance Commissioners;

(ii) $i_{my} = $ for calendar years $y + 11$ and later, .060.

$n =$ Number of guarantee years, and fractions thereof, remaining as of the December 31 valuation.

(b) Contracts having guaranteed interest rates in excess of 6% on future contributions to be received more than one year subsequent to the valuation date.

The same procedures as set forth under (a) above shall be used except that the deduction under (1) of $i_{py}$ shall be .01 instead of .005 and $i_{my}$ for calendar years $y + 1$ through $y + 10$ shall be reduced by .005.

**Table of Values of $i_{my}$**

*(Effective for the December 31, 1977 Valuation)*

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<th>Calendar Year $y$ in Which Contributions Were Received</th>
<th>Value of $i_{my}$ for Calendar Years $y + 1$ Through $y + 10$</th>
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<td>.089</td>
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<td>.087</td>
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<td>1980</td>
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<td>.124</td>
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INTERPRETATION OF MINIMUM CASH SURRENDER BENEFIT UNDER STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

Section 6 of the model bill as written does not require that cash surrender benefits to be paid; but where they are paid, it requires that such cash surrender benefits grade into maturity value using an interest rate not more than one percent higher than the rate specified in the contract for accumulating net considerations. While this method will be suited for contracts having a sales load at issue, it may create a problem for contracts having surrender charges for cash surrender.

For contracts providing cash surrender values, the cash surrender value at maturity shall be at least equal to the minimum nonforfeiture amount at maturity as defined in Section 4. For purposes of calculating cash surrender values prior to maturity, the term “maturity value” in the Standard Nonforfeiture Law for Individual Deferred Annuities shall mean the cash surrender value at maturity.
ACTUARIAL INTERPRETATION REGARDING MINIMUM RESERVES FOR CERTAIN FORMS OF TERM LIFE INSURANCE

Scope

This interpretation recommended by the NAIC Technical Task Force to Review Valuation and Nonforfeiture Value Regulation deals only with term life insurance without cash values which the owner has the unilateral right to maintain in force until its stated expiry date, subject only to the payment of required premiums which vary (generally increasing on a per $1000 basis) during the term of the policy and under which premium rates are guaranteed to the stated final expiry. This interpretation applies only to such term plans valued on the 1958 CSO Mortality Table for the current term period.

Ten-year renewable term, five-year renewable term and one-year renewable term to a stated age with generally increasing premiums are titles commonly given to such policies, but this interpretation concerns itself with the actual coverage provided and is not controlled by the name given the coverage.

Background Information

Historically, reserves on one-year renewable term policies have consisted of a basic reserve for the current term period of one-half the cost of insurance for the current term period, plus a deficiency reserve, if any. The application of the Commissioners Reserve Valuation Method to determine basic reserves and deficiency reserves for such policies is subject to varying interpretations as noted in Walter O. Menge’s paper, “Commissioners Reserve Valuation Method” written at the time of construction of the Standard Valuation Law.

...the adaptation of the commissioners reserve valuation method to fit policies for which the gross premium varies from year to year becomes a problem of generalization which, from a purely theoretical viewpoint, has an infinite number of possible solutions, some of which are practical and others of which are impractical.1

and

For these reasons, it seems desirable not to formulate at this time any fixed rules for the valuation of these unusual types of policies and riders. The second paragraph of Section 4 of the Standard Valuation Law does not define the method of valuation of such contracts but requires that the method used, whatever it may be, must be consistent with that employed for uniform premium policies providing uniform insurance benefits, thus leaving open the possibility of a choice of several consistent methods.2

Acceptable Approaches

Two approaches to “consistent” reserves are suggested. The unitary policy approach considers such policies as variable premium policies up to the mandatory expiry date. Under this approach the valuation net premiums are a uniform percentage of gross premiums with the percentage fixed at issue date. If appropriate deficiency reserves are held, this approach has great appeal. However, it is susceptible to manipulation and illogical results. Reserves according to this approach should be acceptable only if the company can demonstrate that actual reserves, including deficiency reserves, for all renewable term business valued using this approach are of the same general magnitude as would occur using an approved method as defined below.

The other approach is to hold policy reserves for only the current period of years (not necessarily equal to the renewal period) during which the required premium per $1000 remains level, including deficiency
reserves if appropriate. Additional reserves are established where net premiums, calculated on a basis which reflects current mortality, exceed gross premiums for future periods of level premiums. Although not speaking directly to valuation problems in this instance, the Hooker Committee report said:

The question was raised whether a policy providing term insurance for several years, automatically followed by permanent insurance, should be considered as two separate policies for the purpose of the Act. In the Committee’s opinion, the respective portions may be treated separately if the portion providing permanent insurance takes the Company’s regular rate at the then attained age. The rated age provision in the law appears to cover this point. However, the Committee draws a distinction between policies providing purely term insurance followed by permanent insurance at the company’s published rate at the attained age of conversion, and the policies providing for an initial premium such that the increased premium at a subsequent duration differs from that for a new policy at the attained age. The latter case obviously constitutes a single policy to which the formula should be applied at the outset.

The second sentence of the above quotation lends support to the approach of separating successive periods of level premiums.

Under this interpretation, an approved method is any method which produces reserves greater than or equal to the sum of policy reserves, including deficiency reserves, for the current period of level premiums calculated on the basis of the applicable mortality and interest standards and reserve method specified in the Standard Valuation Law plus additional reserves calculated according to the following applied uniformly to all such policies.

The present value of the excess of test premiums for future periods of level premiums for which gross premiums are guaranteed over the respective gross premiums, such test premiums and present values being calculated on the Commissioners’ 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors and 4 1/2 percent interest. For each plan of insurance with separate rates for smokers and nonsmokers an insurer may substitute the 1980 CSO Smoker and Nonsmoker Mortality Tables with Ten-Year Select Mortality Factors for the Commissioners’ 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors.

In case a future gross premium exceeds the test premium, the excess shall be considered zero and not a negative amount. This is in accordance with the principle of anticipating no future profits but providing for all future losses.

Reinsured Business

If reinsurance is assumed under an agreement in which the reinsurer reserves the right to raise premiums to a level at least as great as the net valuation premiums, the reinsurer is not required to establish deficiency reserves or additional reserves, and the ceding company is not permitted to take credit for such reserves on the portion of the business which is required.

If a reinsurance agreement guarantees future reinsurance premiums, the reinsurer should establish deficiency reserves and additional reserves as required by this interpretation for the period for which reinsurance premiums are guaranteed, and the ceding company may take credit for such reserves against its deficiency and additional reserves on the portion of the business which is reinsured to the extent permitted by law.
Adequacy of Reserves

Although the above alternative is acceptable as meeting the intent of the Standard Valuation Law, this does not in any way relieve the certifying actuary of the insurance company from exercising his own best judgment with respect to the appropriate reserves. In particular, the actuary should consider term contracts of this nature when he states his opinion that aggregate reserves “make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies” and “include provision for all actuarial reserves and related statement items which ought to be established.”

References

2. Ibid., p. 300.
Appendix C AG V

Actuarial Guideline V

INTERPRETATION REGARDING ACCEPTABLE APPROXIMATIONS FOR CONTINUOUS FUNCTIONS

Text

For reserves and values using continuous functions:

(a) \[ \overline{D}_x = \int_0^1 D_{x+t} dt \]

By assuming that \( D_{x+t} \) is linear for \( 0 < t < 1 \)
\[ \overline{D}_x = (D_x + D_{x+1})/2. \]

By assuming that the deaths in the year of age \( x \) to \( x+1 \) are uniformly distributed over that year of age,
\[ \overline{D}_x = [(\delta-d)/\delta^2]D_x + [(i-\delta)/\delta^2]D_{x+1} \]

where: \( d = iv = i/(1+i) \)
\( \delta = \) force of interest
\( i = \) interest rate

(b) \[ \overline{C}_x = \int_0^1 D_{x+t} \mu_{x+t} dt \]

By assuming that deaths in the year of age \( x \) to \( x+1 \) are uniformly distributed over that year of age,
\[ \overline{C}_x = (i/\delta)C_x. \]

By assuming that the total deaths are concentrated at the middle of the year of age,
\[ \overline{C}_x = (1+i)^{1/2}C_x \text{ or } (1+i/2)C_x. \]

Background Material

The actuarial mathematics used in calculating net premiums, reserves, and nonforfeiture values for life insurance policies was first developed using two basic assumptions. These basic assumptions are: (1) that all death benefits are payable at the end of the policy year of death and (2) that all gross premiums due under the policy are payable annually at the beginning of the policy year. Actuarial values which are calculated under these two basic assumptions are described as being calculated using curtate functions. For any specific mortality table and interest rate, all the necessary actuarial values are uniquely defined for a policy using curtate functions.

The Standard Valuation Law and the Standard Nonforfeiture Law define minimum reserves and minimum nonforfeiture values, respectively, for life insurance policies using curtate functions. These two model laws originated in the early 1940s when almost all insurance companies were using the two basic
assumptions inherent in the curtate functions. However, the wording of the model laws does not prohibit insurance companies from using other assumptions if the resulting reserves and nonforfeiture values will always be at least as large as the minimum amounts defined in these laws.

Nowadays, many insurance companies do prefer to use alternative assumptions in computing the reserves and nonforfeiture values for their life insurance policies. These companies consider the alternative assumptions more appropriate for their policies. These alternative assumptions are: (1) that all death benefits are payable immediately upon death and (2) that all gross premiums due under the policy are payable continuously throughout the policy year.

Actuarial values which are calculated under both of the alternative assumptions, pertaining to death benefits and gross premiums, are described as being calculated using continuous functions. However, the underlying mathematics for continuous functions involves two integrals, representing the actuarial functions $C_x$ and $D_x$, which must be approximated. In the past, there has been some disagreement among actuaries as to which approximations for the two integrals are the most suitable. Because of the use of different approximations for these two integrals, actuaries have obtained different numerical amounts for the necessary actuarial values using continuous functions even though these actuaries were working with the same mortality table and interest rate.

Some insurance companies prefer to calculate their reserves and nonforfeiture values assuming: (1) that death benefits are payable immediately upon death and (2) that all gross premiums due under the policy are payable annually at the beginning of the policy year. Thus, these companies are using the alternative assumption pertaining to death benefits and the basic assumption pertaining to gross premiums. The underlying mathematics for the combination of these two assumptions involves the integral $C_x$, which must be approximated. Thus, the use of these two assumptions together gives rise to essentially the same problem as using continuous functions.
Appendix C

Actuarial Guideline VI

INTERPRETATION REGARDING USE OF
SINGLE LIFE OR JOINT LIFE MORTALITY TABLES
20 JUNE 1983

The Standard Valuation Law and the Standard Nonforfeiture Law for Life Insurance apply to policies which provide joint life insurance benefits as well as to policies which provide single life insurance benefits. References in these laws to plans such as “nineteen-year premium whole life” or “a whole life policy...with uniform premiums for the whole of life” are to be interpreted as references to such plans based on the same life status(es) as the policy for which minimum reserves or nonforfeiture benefits are being determined. For example, if the net level annual premium on the nineteen-year premium whole life plan is needed to calculate the minimum reserve for a policy which insures two lives and pays a death benefit at the first death, the premium is to be that for a policy which insures two lives and pays a benefit at the first death. The same principle would apply to a policy which insures only one life, or a policy which pays a benefit at the first death of more than two lives. The principle also applies to a policy that pays a benefit on the death of t-th life of n lives (t is greater than 1 but less than or equal to n).

Background Material

The great majority of life insurance policies provide single life insurance benefits. These policies identify one specific individual as the named insured. A death benefit under the basic policy is payable if this named insured dies while the policy is in force. Usually, there are no further gross premiums due on and after the death of this named insured. The basic policy may provide endowment benefits which are conditional on the survival of this named insured. The policy does not contain any provisions whereby the amount of the death benefits, endowment benefits or gross premiums are affected by the survival or nonsurvival of any other persons besides the insured, except possibly in the settlement option provisions or in the provisions of an attached term insurance rider which requires an extra premium.

In contrast to policies which provide single life insurance benefits, policies which provide joint life insurance benefits depend on the survival or nonsurvival of two or more named insureds. Until quite recently, virtually all policies which provided joint life insurance benefits were written on the whole life insurance plan. Such policies paid the face amount as a death benefit on the death of the first of the named insureds to die, provided that the policy was then in full force. No further gross premiums were due after the death, and the policy terminated upon payment of the death benefit.

Recently, there has been increasing interest in plans providing joint life insurance benefits, and insurance companies have developed a variety of new life insurance plans. For example, some policies provide for payment of a death benefit only on the death of the last to die of the named insureds.

The Standard Valuation Law and the Standard Nonforfeiture Law clearly apply to policies which provide joint life insurance benefits as well as to policies which provide single life insurance benefits. Both of these model laws define an “expense allowance” which is added to the present value of the future guaranteed insurance benefits under the policy, and which affects the modified premiums used for computing minimum reserves and the adjusted premiums used for computing minimum nonforfeiture values. A different amount of “expense allowance” is defined for nonforfeiture values than that defined for reserves, but the principle is much the same.

Insurance companies are allowed to select “expense allowances” for use in computing their reserves and nonforfeiture values up to the level of the “expense allowances” defined in these model laws. A higher “expense allowance” would produce reserves or nonforfeiture values which are less than the minimum defined in the model laws, and therefore state insurance departments cannot permit companies to use a higher amount as an “expense allowance.”
The wording of these model laws is generally clear and precise in defining the “expense allowances” which are permitted for policies which provide single life benefits. However, the proper level of the “expense allowances” for policies providing joint life insurance benefits is not so clear. The “expense allowance” defined in the Standard Valuation Law depends on the modified net premium for a policy on the 20-payment whole life insurance plan, and the “expense allowance” defined in the Standard Nonforfeiture Law depends on the adjusted premium for a policy on the ordinary life plan.

Actuaries have had different opinions as to how to apply the joint life insurance mortality tables in order to obtain the modified net premium and the adjusted premium required by model laws, so as to calculate the “expense allowances” which are appropriate under those laws. The question has become increasingly important with the development of the new plans providing joint life insurance benefits.
INTERPRETATION REGARDING CALCULATION OF EQUIVALENT LEVEL AMOUNTS

Text

Pure endowments will not be considered in the determination of equivalent level amounts for valuation and nonforfeiture purposes.

Background Material

The “Background Material” section relating to the previous actuarial guideline went into some detail concerning the “expense allowances” defined in the Standard Valuation Law and the Standard Nonforfeiture Law. See Actuarial Guideline VI, “Interpretation Regarding Use of Joint Life Insurance Tables.”

This Actuarial Guideline VII is also concerned with the level of these “expense allowances” defined in these model laws. The most common plans of life insurance provide a level face amount as the death benefit, during the period the policy is in full force. These plans do not provide for any benefit which is payable as a pure endowment. (A pure endowment benefit pays a specified amount of pure endowment to the policyholder if the insured is still alive on the specified maturity date and if the policy is still in full force on this maturity date.) However, policies which provide for a death benefit which varies with the duration and policies which provide one or more endowment benefits can be legally written in most states.

The Standard Valuation Law and the Standard Nonforfeiture Law do apply to such policies with varying death benefits or pure endowment benefits. In fact, the wording of the model laws shows that considerable thought was given to the treatment of these kinds of policies. In the case of both model laws, the present value of future guaranteed benefits under the policy clearly includes both the death benefits and the “expense allowances” defined under these model laws.

The Standard Nonforfeiture Law includes a paragraph which reads as follows:

In the case of a policy providing an amount of insurance varying with duration of the policy, the equivalent uniform amount thereof for the purpose of this Section shall be deemed to be the uniform amount of insurance provided by an otherwise similar policy, containing the same endowment benefit or benefits, if any, issued at the same age and for the same term, the amount of which does not vary with duration and the benefits under which have the same present value at the date of issue as the benefits under the policy; provided, however, that in the case of a policy providing a varying amount of insurance issued on the life of a child under age ten, the equivalent uniform amount may be computed as though the amount of insurance provided by the policy prior to the attainment of age ten were the amount provided by such policy at age ten.

While the wording of the above paragraph is rather complex, the meaning seems to be actuarially precise. The paragraph defines an “equivalent uniform amount” which affects the “expense allowance” defined in the law. The phrase “containing the same endowment benefit or benefits, if any” effectively means that pure endowment benefits are to be ignored in computing this “equivalent uniform amount.” This “equivalent uniform amount” or “equivalent level amount” becomes a sort of weighted average of the death benefits provided by the policy, an average which is not affected in any way by the pure endowment benefits which may be provided by the policy.

The Standard Valuation Law is not nearly so clear on this point. It contains wording as follows:
Reserves according to the Commissioners Reserve Valuation Method for (1) life insurance policies providing for a varying amount of insurance—shall be calculated by a method consistent with the principles of the preceding paragraph-----.

(Note that the quoted wording refers back to the preceding paragraph in the Standard Valuation Law. It does not intend to refer to the paragraph quoted from the Standard Nonforfeiture Law.)

Most actuaries have interpreted the Standard Valuation Law so as to use an “equivalent level amount” which is not affected by any pure endowments included in the policy. They would then use this “equivalent level amount” to calculate the “expense allowance” defined in the model law. This “equivalent level amount” is also a weighted average of the death benefits provided by the policy, in the same fashion as the “equivalent uniform amount” used in applying the Standard Nonforfeiture Law. Some insurance companies use the same “equivalent level amount,” for the purpose of the Standard Valuation Law, as the “equivalent uniform amount” defined in the Standard Nonforfeiture Law. Other companies use a very similar calculation to obtain a special “equivalent level amount,” for the purpose of the Standard Valuation Law, based only on the death benefits provided on and after the first policy anniversary.

Some actuaries have felt that the wording of the Standard Valuation Law permits an alternate calculation of the “equivalent level amount” which would be affected by pure endowment benefits. Such an “equivalent level amount” would be used to calculate an “expense allowance” under the Standard Valuation Law, even though the “equivalent level amount” no longer has the character of a weighted average of the death benefits provided by the policy.

The inclusion of the pure endowment benefits in the calculation of the “equivalent level amount” would affect the level of the “expense allowance” defined in the Standard Valuation Law, and therefore, it would affect the level of the minimum reserves required by the policy. Typically, the denominator of the fraction used in calculating the “equivalent level amount” would remain the same, but the numerator of this fraction would be increased because of this inclusion. Thus, the “equivalent level amount” itself and the resulting “expense allowance” defined in the Standard Valuation Law would also be increased with the inclusion. The end result of the inclusion would be lower minimum reserves at every duration.

If the amounts and maturity dates of the new pure endowment benefits were carefully selected, a considerable degree of reduction in the reserve factors would probably be possible.

This actuarial guideline would expressly prohibit including the pure endowment benefits in determining the “equivalent level amount” for either valuation or nonforfeiture purposes. As explained under “Background,” the need for this actuarial guideline arises primarily for valuation purposes under the Standard Valuation Law. The wording of the Standard Nonforfeiture Law is sufficiently precise that this actuarial guideline is virtually a truism for the purpose of calculating nonforfeiture values.

The purpose of this actuarial guideline is to assist state insurance departments and insurance company actuaries by identifying a method of calculating “equivalent uniform amounts” and “expense allowances” which is not considered proper and which will not be accepted.
THE VALUATION OF INDIVIDUAL SINGLE PREMIUM DEFERRED ANNUITIES

Text

With respect to those states which have enacted the 1976 amendments to the Standard Valuation Law; individual single premium deferred annuity reserves shall at least equal the greatest of any of the discounted values of all guaranteed future benefits including cash surrender values available after the date of valuation, such benefits discounted to the valuation date at the maximum permissible statutory interest rate. This method applies to all individual single premium deferred annuities which are subject to the provisions of the Standard Valuation Law in those states which have enacted the 1976 amendments. For those states which have not yet enacted the 1976 amendments this interpretation is a method of valuing individual single premium deferred annuities.
Actuarial Guideline IX

FORM CLASSIFICATION OF INDIVIDUAL SINGLE PREMIUM IMMEDIATE ANNUITIES FOR APPLICATION OF THE VALUATION AND NONFORFEITURE LAWS

Text

Solely for the purposes of the applicable Valuation and Nonforfeiture Laws, an individual single premium annuity shall be considered to be immediate, as opposed to deferred, provided:

1. The first annuity payment is due not more than thirteen months from the annuity issue date;

2. succeeding payments under the annuity, after the initial payment, are due at regular intervals no less frequently than annually;

3. in the case of a fixed benefit annuity, the total guaranteed payments due in any contract year are not greater than 115% of the total guaranteed payments due in the immediately preceding contract year. In the case of variable annuities and indexed annuities, the same characteristic would be required for the underlying pattern of payments, before adjustments which are made solely because of the performance of the separate account associated with a variable annuity or the changes in the associated index. (This characteristic is not intended to prevent or reduce any lawful nonguaranteed payments under the annuity which are in the nature of dividends or excess interest credits.)
USE OF SUBSTANDARD ANNUITY MORTALITY TABLES IN VALUING IMPAIRED LIVES UNDER STRUCTURED SETTLEMENTS

Text

The Standard Valuation Law permits modifications of annuity mortality tables. Solely for the purpose of valuing:

1. Periodic benefits arising from settlements of various forms of claims pertaining to court settlements or out of court settlements from tort actions, such as arising from accidents or medical malpractice;
2. Settlements involving similar action such as workers’ compensation; or
3. Settlements of long term disability claims where a temporary or life annuity has been used in lieu of continuing disability payments.

A substandard annuity mortality table may be used where the annuitant (or measuring life) is the injured party and there are relevant hospital records, treating physicians’ reports, and/or independent medical evaluations from those medical doctors that are or have been involved in the care of the injured party, that have been used during the underwriting process and have been retained in the underwriting file of the company as proof of the individual’s impaired health and shortened longevity.

In such case the insurer may modify the statutory annuity mortality table or tables cited in Section 3a of the Standard Valuation Law or in any regulation promulgated pursuant to such section so as to reflect the longevity based on a medical doctor’s written evaluation or records as indicated above. The table may be modified by a percentage of standard mortality or by a specified number of extra deaths or by a combination thereof, provided that the mortality table so adjusted produces reserves that are at least as great as the minimum reserves indicated below. The percentage extra mortality or the specified number of extra deaths may vary by duration. A rated up age with the standard annuity table which is approximately equivalent to the actual age on the substandard annuity table may be used only if the procedure is modified to produce reserves that at each duration are at least as great as the minimum reserves indicated below.

The fact that a company has held minimum reserves as herein described shall in no way relieve the actuary from considering whether such reserves are adequate.

Minimum Reserves

The minimum reserves for applicable annuity contracts are the reserves obtained by making a constant addition to the mortality rate of the otherwise applicable valuation mortality table such that the expectation of life on the adjusted valuation table is greater than or equal to the average of the expectations of life indicated by or obtained from information given by the company’s medical directors or underwriters during the underwriting and pricing process. The constant addition to the mortality table herein described shall be made as of the issue date and, once determined, held constant for the period of time that the contract remains in force. The addition of a constant to the valuation mortality rate produces a gradually declining percentage extra mortality such that reserves will grade into standard reserves at the end of the standard valuation mortality table thereby making the reserve more conservative (closer to standard) each year that the annuitant or measuring life lives.

For annuitants (measuring lives) other than the injured person in such settlements, the actual age and a standard annuity mortality table specified in Section 3A of the Standard Valuation Law or in any
subsequent regulation promulgated thereto or any modification of such table which produces reserves at least as high as those that would be produced under the standard table based on the actual age must be used.

For contracts not included in one of the three categories described in the first paragraph of the Guideline, standard reserves at the actual age shall be held.

Where an insurer uses a modified table with higher mortality rates or a rated age with an unmodified table for impaired lives under structured settlements, such insurer shall maintain records of actual to expected mortality to monitor the appropriateness of the substandard mortality.

**Background**

Structured settlements take their name from the fact that the settlements, which arise from tort action, including workers’ compensation claims, are frequently structured to fit the circumstances of the injured party and/or the injured party’s dependents. The injured party and/or dependents are apt to be much younger than normal retirement age such that the payments may well stretch out for 30, 40, and 50 years or more. Some payments are certain; others are contingent upon the measuring life being alive at the time of payment.

The volume of structured settlement business has boomed in recent years. Periodic and deferred payments have been encouraged and even mandated in some states as a means of controlling costs under malpractice claims and ensuring that the monies would be available in future years and not squandered as could happen with lump sum payments. Periodic and deferred payments may be a result of settlement of automobile claims, other accidents involving tort action, as well as workers’ compensation claims and medical malpractice claims, where the individual(s) upon which the tort or other action was based may well be substandard.

At the time of the adoption of the NAIC 1980 revisions of the Standard Valuation Law (SVL), structured settlement business was relatively minor, and how to treat such business was not explicitly covered in the SVL.

The SVL allows for modification of the standard annuity mortality table specified in the minimum valuation standard. Any modification had traditionally been such as to result in higher reserves. If lower reserves were produced, it could render the minimum meaningless.

In case of structured settlements, the injured party may be highly substandard. If an insurance company had to set up reserves on a standard table, or on a basis that grades into standard mortality too rapidly, it could result in either an excessive price for the payments or it could result in such a level of surplus strain to the insurer. If the price reflects the actual expected mortality, that the coverage might not be offered at all. To encourage settlements involving periodic payments, it is recommended that, in the limited area involving the injured party, the table may be modified so as to reflect the expected mortality based on the relevant medical records, reports and/or evaluations described earlier.

Since this is an area with little experience, it is required that an insurer monitor the experience in order to be able to justify its choice of adjusted mortality assumption.

It is recognized that at issue the vast bulk of the liability normally pertains to payments that are certain and not contingent upon survival, since the vast majority of substandard contracts contain a certain period and most of the benefits either fall within that certain period or are guaranteed to be paid. It is also noted that the interest discount factor in the early durations is far more important than the mortality element. The selection of the interest discount factor is the subject of Guideline IX-B.
Because experience and methodology are still emerging for substandard annuities, it is expected that this whole subject will be reviewed again in the not too distant future, both as it applies to whether the criteria herein established for settlement annuities are too conservative and also whether or how it might be acceptable to apply similar standards to substandard non-settlement annuities.

**Effective Date**

Where the requirements of this Guideline produce higher reserves than those calculated by an insurer, such insurer may continue its present procedures for the 1989 year end valuation, but must comply with this Guideline for 1990 and later issues for the 1990 and later valuations and for all of its business by the 1993 year end valuation.
Text

1. Solely for the purpose of applying the Standard Valuation Law, an annuity shall be considered as a series of payments not less frequently than annually over five years or more wherein the payments in any one contract or calendar year (at the option of the insurer) do not exceed 115% of the payments in the immediately preceding contract or calendar year. An immediate annuity is an annuity wherein the first payment begins in thirteen months or less from issue and a deferred annuity is an annuity wherein the first payment begins more than thirteen months after issue. A series of payments over less than five years otherwise qualifying as an annuity shall be considered equivalent to a lump sum. Any payments in a year in excess of 115% of the prior year’s payments may be considered as a lump sum or equivalent thereto or may be considered as part of a new annuity depending on the circumstances. Some contracts may consist of combinations of annuities and of lump sums.

2. Where the deferred income payments are guaranteed and there are no cash settlement options, the reserve shall be based on the present value of the income payments based on an appropriate annuity mortality table and the valuation rate of interest in accordance with the Standard Valuation Law based on the issue year method and a guarantee duration equal to the number of years from the date of issue to the date the first payment begins.

3. At the time benefit payments begin, whether under single premium immediate annuity contracts, supplementary contracts providing for annuity payments or deferred annuity contracts (with the first payment deferred more than thirteen months), the insurer may use the valuation interest rate for the calendar year in which (a) the deferred contract was issued or (b) the consideration was received or (c) the payments begin, but must apply such procedure elected in a consistent manner

4. Individual structured settlements vary considerably in payment pattern and duration. These contracts may provide for both level and/or increasing periodic payment schedules, as well as lump sum benefit payments. In valuing individual structured settlements, a split of all or a portion of the lump sum payments from the annuity payments may be appropriate. Such splits should be at the discretion of the valuation actuary. However, splits not in accordance with (5)(a) or (5)(b) and with (6)(a) below would require valuation in accordance with procedure (6)(b) or (6)(c) below.

5. For a block of single premium immediate annuities, deferred annuities without cash settlement options, structured settlement business with the annuity portion having no cash settlement options, or other contracts having some portion with periodic payments without cash settlement options, issued in a given calendar year, the calendar year valuation interest rate appropriate for single premium immediate annuities where the first payment begins in thirteen months or less after issue and for Plan Type A contracts without cash settlement options based on the date to first payment where the first payment begins more than thirteen months after issue may be used provided:

a. The guaranteed payment under each contract in the block due in any contract or calendar year (at the option of the insurer) after the first is not greater than 115% of the guaranteed payment due in the immediately preceding contract or calendar year, and once payments
begin such payments are not less frequent than annually and are payable over five years or more; or

b. The total guaranteed payments under all contracts combined included in the block due in any calendar year after the first are not greater than 110% of the total guaranteed payments due in the immediately preceding calendar year but only contracts having payments not less frequent than annually for at least five years shall be included.

The year to year comparison of benefits may be made before or after considering the effect of mortality or any certain period, but the actuary should be prepared to indicate which method is used.

6. If a block of immediate annuities, deferred annuities without cash settlement options, structured settlement contracts with the annuity portion having no cash settlement options, or other contracts having some portion with periodic payments without cash settlement options fails the test described in (5) above, then one of the following procedures must be used:

a. The block must be divided into components so that the contracts/payments satisfying the tests are included in one or more components and those not satisfying the tests are included in another component or other components. The Plan Type A valuation interest rate or rates may be used for the component or components which satisfies the test. The Plan Type A guarantee duration is the number of years from the date of issue or date of purchase to the date that the first annuity payment is due. The maximum valuation interest rate for any payment included in a component which does not satisfy the test shall be determined using the guarantee duration of the lump sum payment including installments over less than five years and on the assumption that the payment is made under a contract of Plan Type A. The Plan Type A guarantee duration of a lump sum payment is the number of years from the date of issue or date of purchase to the date that payment or the first installment payment is due. Year of issue valuation interest factors must be used. The actuary should be prepared to describe the components and justify the choice of valuation interest rate or rates for the component or components of the block which, if included, would cause the block to fail the test.

b. The reserves for each contract for each valuation year shall be the greater of the “level interest rate reserves” and of the “graded interest rate reserves.” Graded interest rate reserve factors for each separate year of issue for all future payments of such year of issue, whether periodic or lump sum payments, shall be graded in a manner that produces reserves at least as great as the method described in the balance of this paragraph.

(i) Step one, calculate the present value of future benefits at issue for each contract using the appropriate level Plan Type A interest rate for contracts without cash settlement options for the guarantee duration corresponding to the number of years from the date of issue or date of purchase to the date that the first payment is due. Call this value PV (0), and call reserves at successive durations using the appropriate (level) Plan Type A interest rate “level interest rate reserves.”

(ii) Step two, solve for “X percent” such that the present value of future benefits at issue for each contract is equal to PV (0) (calculated in Step one), using “X percent” as the valuation interest rate for the first twenty contract years after issue and thereafter the Type A interest rate for contracts without cash settlement options for guarantee durations of more than twenty years. However, “X percent” shall not be greater than 115% of the appropriate Type A interest rate in step one; where such limit is effective, the present value at issue will be greater than PV (0).
(iii) For each valuation year calculate “graded interest rate reserves” based on the assumption that the valuation interest rate during the first twenty contract years is “X percent” as calculated in step two and thereafter is the Plan Type A interest rate for contracts without cash settlement options for guarantee durations of more than twenty years.

(iv) In lieu of the individual contract valuation above, a group valuation may be made as for example on the assumption that all contracts issued during a given year are issued as a single contract on July 1, and once X% is determined for such year, it need not be redetermined; or

c. Any other method producing reserves at least as great as (a) or (b) and specifically approved by the Commissioner.

7. Where the requirements of this guideline produce higher reserves than those calculated by an insurer in good faith based on a more liberal interpretation, such insurer may continue its present procedures for the 1989 year end valuation but must comply with this guideline for 1990 and later issues for the 1990 and later year end valuations and for all its inforce, subject to the 1980 amendments to the NAIC Model Standard Valuation Law, by the 1993 year-end valuation.

8. The examiner should request that the insurer demonstrate that the assets are sufficient for the liabilities by cash flow projections of the supporting assets and the liabilities under various interest scenarios, in particular for declining interest rates.

9. The examiner should note that date of acquisition and the yields of the supporting assets and compare such with the date of issue of the structured settlements and the valuation interest rates. If such differ, the examiner may request a new valuation using the date of acquisition of the majority of the supporting assets as the date of issue of remaining payments. This is especially important where, for example, an insurer during 1986 exchanged high yielding assets originally acquired in 1982 for low yielding assets acquired in 1986. Also, many of the high yielding assets may have been called during 1986. Also, due to the long-term nature, often as many as 30, 40, and 50 years, the increasing nature of the payments and the lump sum payments, the value of future payments with a single fixed interest rate may actually increase after issue. The result is that there is a large reinvestment risk and large liabilities may exist after all the original supporting investments have matured and new investments acquired.

10. The procedures above are interim procedures pending a reconstitution of the valuation laws.

Background

Current Actuarial Guideline IX provides guidance for determining what is an immediate annuity but it does not advise how contracts failing to meet the test should be treated for valuation purposes. Three examples of failing contracts are: (1) annual payments increasing 120% each year, (2) level payments payable biannually, (3) level annual payments with extra lump sum payments equal to four times a regular annual payment payable every five years. These examples are not practical examples for annuity payments beginning at normal retirement ages such as 60, 65 or 70 under individual or group retirement programs, but combinations of irregular payments and increasing regular payments are practical under structured settlements.

At the time of the adoption of the NAIC 1980 revisions of the Standard Valuation Law, structured settlement business was relatively minor, and how to treat such business was not explicitly covered in the SVL. The volume of structured settlement business has boomed in recent years. Periodic and deferred payout was encouraged and even mandated in some states as a means of controlling costs under malpractice claims and ensuring that the monies would be available in future years and not squandered as
could happen with lump sum payments. Periodic and deferred payments may result in settlement on automobile claims, other accidents involving tort action as well as medical malpractice claims and workers’ compensation claims such that the individuals may well be substandard.

Where payments are contingent on the individual being alive, under a related guideline, substandard annuity mortality tables may be recognized for valuation based on a written evaluation of the injured individual’s longevity by a medical doctor. For all other annuitants, substandard annuity mortality tables should not be recognized as such is contrary to the establishment of minimum reserves for such annuitants. However, the vast bulk of reserves for structured settlements is based on certain payments, such that the valuation interest rate is by far the more important factor. This guideline covers valuation procedures and valuation interest rates leaving application of substandard annuity mortality table to Guideline IX-A.

Structured settlements take their name from the fact that the settlements are frequently structured to fit the circumstances of the injured party and/or the injured party’s dependents. The injured party and/or dependents are apt to be much younger than normal retirement age such that the payments may well stretch out for 30, 40, and 50 years or more. Lump sum payments may be scheduled to coincide with particular events such as college for dependent children.

The 1980 changes in the SVL initiated a set of valuation interest factors for each year of issue so as to roughly have the factor correspond to the investment rates at the time at which monies are received and invested. In 1980 the emphasis in the dynamic valuation interest rate was on the valuation interest rates for group guaranteed interest contracts (GIC). Group GIC’s generally have had a guaranteed interest period of 5-10 years with a lump sum available at the end of the period. Any renewal of an interest guarantee and period is generally considered as a new issue for valuation purposes, whether the year of issue or the change in fund method is used.

Most retirement annuities under individual or group programs had level or slightly increasing payments with payments beginning at age 60, 65 or 70, such that for annuities in course of payments, there should be little reinvestment risk and reserves should decrease.

There is a large reinvestment risk in case of structured settlements. There is also a risk that the original assets may be called or exchanged for lower yielding assets.

Guideline IX-B would split up the contract and treat that portion of the payments meeting the test as an annuity and any excess payments separately for purposes of determining the appropriate valuation interest factors based on the duration to first payment of such excess. The guideline also offers a new dual interest procedure as an alternative to splitting the payments.

The guideline recognizes that the use of the statutory formulae with the rates determined based on the date of purchase may be inappropriate where the assets have been exchanged or acquired in later years. It is suggested that the examiner may wish to adjust the issue year for selection of the valuation interest factors so as to make them consistent with the date of investment.

It is recognized that these procedures for determining statutory formulae reserves are only temporary while the Special Committee on Valuation is developing a new statutory formula to go along with a valuation of liabilities based on the supporting assets and the actuary’s best judgment to account for reasonable deviations.
USE OF SUBSTANDARD ANNUITY MORTALITY TABLES IN VALUING IMPAIRED LIVES UNDER INDIVIDUAL SINGLE PREMIUM IMMEDIATE ANNUITIES

The NAIC model Standard Valuation Law, Section 4a, A(2), permits modifications of annuity mortality tables approved by the commissioner. In states which have adopted this or similar Standard Valuation Law language, this guideline provides for modifications of annuity mortality tables solely for the purpose of valuing:

Individual single premium immediate annuities not covered by Guideline IX-A, but for which medical records indicate the expectation of life has been reduced and for which the premium charged reflects such reduction,

a substandard annuity mortality table may be used where the annuitant (or measuring life) has relevant hospital records, treating physicians' reports, and/or independent medical evaluations from those medical doctors that have been used during the underwriting process and have been retained in the underwriting file of the company as proof of the individual's impaired health and shortened longevity. The medical assessment must support at least a 25% reduction in the expectation of life (based on either the current valuation table or the company’s pricing table, consistently applied) compared to a normally healthy individual at the same age and gender.

In such case the insurer may modify the statutory annuity mortality table or tables cited in Section 3a of the Standard Valuation Law or in any regulation promulgated pursuant to such section so as to reflect the longevity based on a medical doctor's written evaluation or records as indicated above. The table may be modified by a percentage of standard mortality or by a specified number of extra deaths or by a combination thereof, provided that the mortality table so adjusted produces reserves that are at least as great as the minimum reserves indicated below. The percentage extra mortality or the specified number of extra deaths may vary by duration. A rated up age with the standard annuity table which is approximately equivalent to the actual age on the substandard annuity table may be used only if the procedure is modified to produce reserves that at each duration are at least as great as the minimum reserves indicated below.

The fact that a company has held minimum reserves as herein described shall in no way relieve the actuary from considering whether such reserves are adequate.

Minimum Reserves

The minimum reserves for applicable annuity contracts are the reserves obtained by making a constant addition to the mortality rate of the otherwise applicable valuation mortality table. The amount of the constant addition is determined as follows:

1) Calculate the present value of future benefits at issue for each contract using a rated up age, the applicable valuation mortality table, and the appropriate level Plan Type A interest rate for contracts without cash settlement options. The rated up age must produce an expectation of life under this valuation mortality table whose percent reduction from the actual age expectation of life under this table is not greater than the percent reduction in the expectation of life, supported by the medical assessment above, which qualified the contract to utilize the mortality adjustments provided by this actuarial guideline.

2) Solve for the constant addition to the true age mortality rates such that the present value of future benefits at issue is equal to or greater than the present value obtained in 1). The base mortality table and the valuation interest rate shall be the same as used in 1).
The constant addition to the mortality table herein described shall be made as of the issue date and, once determined, held constant for the period of time that the contract remains in force. The addition of a constant to the valuation mortality rate produces a gradually declining percentage extra mortality such that reserves will grade into standard reserves at the end of the standard valuation mortality table thereby making the reserve more conservative (closer to standard) each year that the annuitant or measuring life lives.

Where an insurer uses a modified table with higher mortality rates or a rated age with an unmodified table for impaired lives under individual single premium immediate annuities, such insurer shall maintain records of actual to expected mortality to monitor the appropriateness of the substandard mortality. The appointed actuary must comment on the appropriateness of the substandard mortality and report any material deviations. Such comments and report should be provided in the actuarial memorandum which supports the annual actuarial opinion.

**Background**

Guideline IX-A provides a methodology to allow less than a standard reserve to be held at issue for certain kinds of pay-out annuities and for grading the reserve toward standard reserves over the remaining lifetime of the annuitant using the “constant extra death” method (CED). The longer the annuitant lives, the closer reserves get to standard reserves.

Guideline IX-A says, “Because experience and methodology are still emerging for substandard annuities, it is expected that this whole subject will be reviewed again in the not too distant future, both as it applies to whether the criteria herein established for settlement annuities are too conservative and also whether or how it might be acceptable to apply similar standards to substandard non-settlement annuities”.

It has now been almost 11 years since Guideline IX-A was adopted and it appears the industry has done a responsible job of underwriting and valuing substandard annuities covered by Guideline IX-A. Structured settlement mortality studies done by the Society of Actuaries bear this out. (See the 1995-1996 Reports of the Society of Actuaries, starting on page 395.)

Guideline IX-A has been successful in allowing structured settlements to be priced fairly and has benefited injured parties and society in general. There is no evidence that there has been any strain to insurance companies from underreserving due to Guideline IX-A.

For some time, a number of companies have had a significant and increasing opportunity to provide immediate annuities at less than a standard price to a growing number of potential clients not covered by Guideline IX-A. However, the potential price reductions that the industry can give consumers, perhaps 15% to 25% of the single premium on some cases, depending on the benefit stream desired, are greatly reduced because of the current requirement to hold standard reserves. The initial statutory strain (loss) on highly substandard cases can easily exceed 50% or 100% of the single premium, which requires a significantly increased price to the customer over what could be charged if less than standard reserves were permitted. With Guideline IX-A type reserves, the strain might be reduced to something closer to 10%.

The population is aging and the need for fairly priced single premium immediate annuity benefits is substantially increasing. Forcing companies to hold standard reserves results in many people being overcharged (for the extra cost of capital associated with the higher reserve) at a time in their life when they may have the greatest need.

Since this is an area with little experience, it is required that an insurer monitor the experience in order to be able to justify its choice of an adjusted mortality assumption. It is recognized that the initial liability pertains to a large extent to payments that are certain and not contingent upon survival. This is because the majority of non-settlement substandard contracts contain a certain period and most of the benefits fall...
within that certain period. It is also noted that the interest discount factor in the early durations is far more important than the mortality element. The selection of the interest discount factor is the subject of Guideline IX-B.

Because the standard annuity valuation table is an aggregate table, there is some concern that carving out the substandard lives may cause the table to be inadequate for the remaining lives. As a result, it is recommended that an individual life have a significant impairment before use of a substandard valuation table is allowed. For this purpose, significant has been defined as a medical condition that reduces the expectation of life of the individual by at least 25% compared to a normal, healthy life. The reasoning is that not very many lives that are significantly substandard (i.e. greater than a 25% reduction in the expectation of life) are contained in the underlying mortality of individual non-settlement annuity mortality tables. Thus, treating them separately will not diminish the adequacy of the standard table. For convenience, either the applicable individual annuity valuation table or the company’s pricing table can be used to measure the change in the expectation of life.

A public policy issue was discussed wherein this actuarial guideline could be viewed as rewarding unhealthy behavior. However, this actuarial guideline would benefit others who were simply unfortunate to be in an impaired condition. It was noted that it would be difficult or impossible to carve out those with intentionally unhealthy behavior. Ultimately it was believed that this actuarial guideline provides for reasonable public policy to facilitate lower single premiums for substandard annuitants.

**Effective Date**

This Guideline will be effective for contracts issued on or after January 1, 2001.
GUIDELINE FOR INTERPRETATION OF NAIC STANDARD NONFORFEITURE LAW FOR INDIVIDUAL DEFERRED ANNUITIES

Text

For contracts which provide cash surrender benefits, the NAIC Model Law prescribes a basis for determination of minimum cash surrender benefits. That law does not require that a company grant additional amounts in excess of the amounts guaranteed in the contract, either in the form of excess interest credits or otherwise. When such additional amounts have been credited to the contract, the question of how the Model Law applies to such amounts must be considered.

Under one interpretation the portion of the maturity values which would arise from such amounts may be discounted to the date of surrender at an interest rate 1% higher than the rate specified in the contract for accumulating such amounts. This interpretation would permit a surrender charge against such amounts on the same basis as the surrender charge which may be applied to the contractually guaranteed portion of the interest credited to the contract.

Under another interpretation such amounts could not be treated as providing a portion of the maturity value and, therefore, would be included in the phrase “any additional amounts credited by the company to the contract.” This interpretation would require that the cash surrender value be increased by 100% of the accrued value of such amounts.

By providing for a surrender charge to be made in determining the minimum cash surrender value, the Model Law enables a company to provide for recovery of all or part of any (1) excess first year expenses not yet recovered, and (2) potential investment losses at surrender. The reason for permitting surrender charges to be made against accumulated amounts of contractually guaranteed interest are equally valid reasons for permitting surrender charges against any non-guaranteed interest credited. If such surrender charges were not permitted, companies offering such contracts may be discouraged from crediting as much additional interest as they might if the additional interest were to contribute to the minimum cash surrender value in the same manner as do the interest amounts derived from the rates guaranteed in the contract.

In view of the above considerations, the following guidelines are recommended:

I. Treatment of Amounts of Excess Interest Credited to Deferred Annuity Contracts

The NAIC Standard Nonforfeiture Law for Individual Deferred Annuities shall be interpreted to permit the portion of the maturity value which would arise from the amounts of interest credited in excess of the minimum rates guaranteed in the contract to be discounted to the date of surrender at an interest rate 1% higher than the rate specified in the contract for accumulating such amounts, provided such excess interest is declared prior to the period for which it is to be effective, and provided such excess interest accrues over the effective period. Amounts of excess interest treated in accordance with the above interpretation shall not be included by the phrase “additional amounts credited by the company to the contract” in Section 6 of the Model Law.

II. Treatment of Dividends Credited to Deferred Annuity Contracts

No single rule can be given for the treatment of dividends credited to deferred annuity contracts. The contractual wording of the applicable dividend option must be taken into account together with the appropriate provisions of the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities.
If the dividend option in effect provides that dividends be left on deposit at interest, without any further qualification, then the cash surrender value should be increased by the full accumulated amount. In this case, the phrase “increased by any additional amounts credited by the company to the contract” applies and no surrender charge may be made.

In other cases, the dividends may be added, directly or indirectly, to the contractual value and made subject to the surrender charge provision. This would be the case when dividends are applied to purchase additional paid-up benefits or applied as premiums.

Contracts may contain other provisions or variations of these provisions. In such cases, the terms of the contract and the provision of the NAIC Standard Nonforfeiture Law for Individual Deferred Annuities should be taken into account.
Appendix C

Actuarial Guideline XI

EFFECT OF AN EARLY ELECTION BY AN INSURANCE COMPANY OF AN OPERATIVE DATE UNDER SECTION 5-C OF THE STANDARD NONFORFEITURE LAW FOR LIFE INSURANCE

Section 5-C of the Standard Nonforfeiture Law for Life Insurance May be Made Operational for One or More Plans at a Time Provided That:

A. Sales are discontinued in this state on all like plans using rates and values generated by past requirements;

B. Sales are discontinued in all other states which have enacted the new legislation on all like plans using rates and values generated by past standards, provided the state of sale has allowed changes to 1980 requirements on a plan-by-plan basis;

C. Once the new law has been made operational for one plan, the new law shall be operational for all subsequent new plans of the same generic form to be marketed in this state unless the insurer can demonstrate to the Commissioner’s satisfaction the need to continue the prior set of requirements;

“Like plans,” as mentioned in Sections A and B, refers to plans with the same benefits, including cash values, and with the same premium paying period and pattern of premiums;

“Generic form,” as mentioned in Section C, refers to generic groups, such as ordinary vs. group, term vs. permanent, flexible cash value vs. fixed cash value, separate account vs. fixed account.
ACTUARIAL GUIDELINE XII WAS WITHDRAWN ON MARCH 7, 1993
Actuarial Guideline XIII

GUIDELINE CONCERNING THE COMMISSIONERS’
ANNUITY RESERVE VALUATION METHOD

Preamble

At its December 1976 meeting, the NAIC adopted the Commissioners’ Annuity Reserve Valuation Method (CARVM) and incorporated it in its Model Standard Valuation Law. CARVM is now included in the laws of nearly all of the states. Differences in interpretation of CARVM have developed in practice, particularly on whether and under what conditions surrender charges may be taken into account in determining CARVM reserves. This guideline is intended to clarify which surrender charge factors may be taken into account and which are to be disregarded under CARVM.

Reserves according to CARVM depend in part upon the present values of “future guaranteed benefits, including guaranteed nonforfeiture benefits.” It has always been recognized that this phrase, as used in the NAIC Model Standard Valuation Law, includes cash surrender values based on contractual guarantees after reduction for any contractual surrender charges available to the insurer. This is illustrated in the Proceedings. See Proceedings of the National Association of Insurance Commissioners, Vol. 1 (1977), 538-45.

Guideline

The phrase, “future guaranteed benefits, including guaranteed nonforfeiture benefits,” as used in CARVM include the cash surrender values based on contractual guarantees after reduction for any surrender charges available under the contract.

In recent years, annuity contracts with contingent surrender charges have become more prevalent. For example, a contract may provide the option to surrender without surrender charge if the rate at which interest is credited falls below a specified rate, referred to in this guideline as the “bail-out” rate. Contingent surrender charges may not be available upon cash surrender at future contract anniversaries, and it is not consistent with the conservative nature of CARVM to reduce the value of future guaranteed benefits on account of such contingent surrender charges.

The value of future guaranteed benefits under CARVM may not be reduced by contingent surrender charges which may not be available upon cash surrender.

There may be some contracts with contingent surrender charges with bail-out rates which are so low that it would not be contrary to the conservative intent of CARVM to treat such surrender charges as available. The calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years, which is used in the Standard Valuation Law in connection with the definition of guaranteed duration for most annuities and guaranteed interest contracts, provides an appropriate measure for this purpose. Whether or not such surrender charges should be treated as available should be determined as of December 31, 1984 for contracts in force at the date and as of the date of issue for contracts subsequently issued.

For contracts issued on and after January 1, 1985, contingent surrender charges with bail-out rates less than or equal to the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years issued in the same year may be treated as available. For contracts issued prior to January 1, 1985, contingent surrender charges with bail-out rates less than or equal to 6.00% (the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years issued in 1984) may be treated as available.
There are some contracts with contingent surrender charges with bail-out rates which are a function of an external index whose future values are not known. Judgment is required to determine whether or not such surrender charges may be treated as available. Comparison to the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty years may be useful.

For contracts with contingent surrender charges with bail-out rates which are a function of an external index, a judgment as to the availability of the surrender charges may be made by comparing historical values of the function with corresponding values of the calendar year statutory valuation interest rate for life insurance with guarantee duration in excess of twenty years. If the values of the function have generally been less than or equal to the valuation rates, then the surrender charges may be treated as available.

For the purpose of this guideline, in the case of a variable annuity that offers the policyholder a choice of multiple investment options, a surrender charge that may be waived for all the accounts of the contract by reference to one or more of the accounts will be treated as a contingent surrender charge that may not be available upon cash surrender with respect to the entire contract. If no surrender charge is imposed on transfers among the accounts, and the surrender charge may be waived for one account, provided the formula for the availability of the waiver is set at the date of issuance, then the surrender charge will be treated as a contingent surrender charge that may not be available upon cash surrender with respect to the entire contract.

Since this guideline is intended to apply to all contracts in force that are subject to CARVM, its application may work an undue hardship on some insurers who have, on the basis of a good faith interpretation of CARVM, held reserves less than required by this guideline. In cases of severe hardship, state insurance commissioners may wish to permit insurers to conform on a gradual basis.
SURVEILLANCE PROCEDURE FOR REVIEW OF THE ACTUARIAL OPINION FOR LIFE AND HEALTH INSURERS

To assist regulators in their responsibility for surveillance of life and health insurers, the NAIC adopts the following interim procedure for use of the Actuarial Opinion to be used until such time as model legislation and/or regulations are adopted and become effective.

1. The regulator should accept Actuarial Opinions only from qualified actuaries. The educational and experience standards established by the American Academy of Actuaries for this purpose offers evidence that an individual is so qualified.

2. The regulator should determine if an opinion is qualified in any respect, or omits items from the outline provided in the Instructions to the Blank. If so, a follow up with the actuary rendering the opinion as to the nature of the qualification or omission is appropriate if the opinion does not provide a satisfactory explanation.

3. The regulator should examine the circumstances where the actuary rendering the opinion differs from the prior actuary, and ascertain the reasons for the change. In some cases the regulator may wish to discuss the change with the current and prior actuaries.

4. The regulator should, if desired, obtain for reviews, documentation supporting the Actuarial Opinion. Except in matters of professional discipline, the regulator’s use of these documents should be considered within the department’s guidelines for confidential information.

5. The regulator may require that the actuary furnish an Actuarial Report supporting the Actuarial Opinion. The report should conform to the standards of the American Academy of Actuaries with respect to Actuarial Reports (Opinion 3 to the Guides to Professional Conduct). It should document the methodology and approach to assumptions used in making the opinions and, additionally, provide specific details in reference to items in 6 through 10 below if such details are required by the regulator.

6. In the Actuarial Report, the actuary providing the opinion should refer to the NAIC Insurance Regulatory Information System (IRIS) ratios, point out ratio values outside the prior year’s range of usual values, and provide explanations for those which are significant.

7. In the Actuarial Report, the actuary providing the opinion should make specific reference to the extent to which the good and sufficient analysis considered all the unmatured obligations of the company, in aggregate, guaranteed under the terms of its policies. (Note: To the extent that the insurer declares guarantees more favorable than those in the policy, such declared guarantees shall be used in the calculation of all the unmatured obligations.)

8. In the Actuarial Report, the actuary providing the opinion should make specific reference as to whether the good and sufficient analysis, with respect to annuities and other products with benefits (guaranteed or non-guaranteed) sensitive to interest rates, considered future insurance and investment cash flows as they would emerge under a reasonable range of future interest rate scenarios, and, if so, what those considerations were.

9. In the Actuarial Report, the actuary providing the opinion should make specific reference as to whether the good and sufficient analysis considered the inter-relationships of assumptions with respect to guaranteed benefit payments, future expenses, policyowner dividends, and post-issue premium or benefit adjustments, especially among persistency, mortality, morbidity, inflation, and interest rates, and, if so, what those considerations were.
10. In the Actuarial Report, the actuary providing the opinion should document the extent to which the opinion is influenced by a continuing business assumption, and, if the impact is material, comment on the company’s plan of operations with regard to this assumption as it affects assumed expenses and interest rates, and future reserve requirements.

11. A review of the documentation obtained in (4) above, undertaken or sponsored by the regulator, should:

   a. Be done by a qualified reviewer;

   b. Emphasize an examination of the appropriateness of the actuary’s work process, methodology, and approach to assumptions.

12. If at any time during the review, the regulator requires more information deemed to be material to the development of the opinion, the company would be expected to comply with requests for such information.
ILLUSTRATIONS GUIDELINE FOR VARIABLE LIFE INSURANCE MODEL REGULATION

Any sales illustration shown or furnished in connection with the sale of variable life insurance must conform with the following requirements except that these requirements only apply to the variable portion of contracts with fixed and variable funding options. Item 9 specifically pertains to variable life insurance contracts offering both fixed and variable funding options.

1. The hypothetical interest rates used to illustrate accumulated policy values must be an annual effective gross rate after brokerage expenses and prior to any deduction for taxes, expenses and contract charges.

2. If illustrations of accumulated policy values are shown then for the highest interest rate used, one illustration must be based solely upon guarantees contained in the policy contract being illustrated. (For example, if the illustration includes the effect of mortality charges and administrative charges which are below the guaranteed maximums for such charges, an illustration must be prepared which involves the effect of the maximum charges.)

3. Except for illustrations contained in the prospectus, the pattern of premium payments used in an illustration should be the initial pattern requested by the proposed policyholder at inception or upon changes in face amount requested by the policyholder.

4. If the illustrated policy contract provides for a variety of investment options, the illustration may either use an asset charge which is reasonably representative or use the asset charge of a particular option. The illustration should clearly identify the asset charge and either label it “hypothetical” or identify the fund.

5. The illustration must disclose the transaction charges which will be levied against the contract because of transactions requested in accordance with rights and privileges specified in the policy contract. Any charge for the exercise of a right or privilege upon which the illustration is based must be reflected in the illustrated values. The nature of any other such charges must be disclosed in a clear statement accompanying such illustrations. (For example, a charge to switch from one investment option or death benefit option to another.)

6. A clear statement must be made following the Table of Illustrated Accumulated Policy Values that use of hypothetical investment results does not in any way represent actual results or suggest that such results will be achieved and must indicate that the policy values which actually arise will differ from those shown whenever the actual investment results differ from the hypothetical rates illustrated. Assumptions upon which illustrations are based must be clearly disclosed.

7. Any sales illustration to a prospective policyholder must reflect the policy being presented accurately. Misleading statements or captions or other misrepresentations are prohibited.

8. The requested sales illustration must be printed clearly and legibly on hard paper copy. An illustration displayed on a computer screen may be used in addition to, but not as a substitute for, hard paper copy.

9. In connection with variable life insurance contracts offering both fixed and variable funding options:

   a. An illustration of the variable funding option must comply with these guidelines;
b. If an illustration of the fixed funding option is shown, accumulated policy values must be shown on the basis of guaranteed rates. One or more additional rates may also be shown but such rates may not exceed current rates;

c. A summary illustration may be given in which results from comparable illustrated and hypothetical interest rates are combined. Such summary must cross-reference to the accompanying separate illustrations of the fixed and variable funding options.

10. Nothing herein shall prohibit the distribution to the prospective policyholder of illustrations in addition to those required by Article VII of the NAIC Model Variable Life Insurance Regulation provided that, except for Item 3 which shall only apply to required illustrations under Article VII, such additional illustrations comply with the standards set forth herein.
When CRVM reserves are being calculated, it is necessary to determine the value of $19P_{x+1}$. The Standard Valuation Law permits the use of Select Mortality Factors with the 1980 CSO Table. While the maximum valuation interest rate for any policy is level for all durations, the law permits the use of other interest rates as long as the resulting reserves are not less than those according to the minimum standard. Thus, it is possible to calculate reserves by the CRVM method using split interest rates, i.e., interest rates that are not the same at all durations.

When either Select Mortality Factors or split interest are involved, the “net level annual premium on the nineteen-year premium whole life plan” is the renewal net level premium for a 20-payment life valued on the full preliminary term basis. That is $19P_{[x]+1}$ should be used instead of, for example, $19P_{[x+1]}$.

**Background Information:**

The Report of the Society of Actuaries Committee on Specifications for Monetary Values - 1980 CSO Tables recommended this approach. This Report was accepted by the Board of Governors of the Society and forwarded to the NAIC early in 1984. This approach is logical because it is consistent with the calculation of the “net level annual premium equal to the present value, at the date of issue, of such benefits provided for after the first policy year, divided by the present value, at the date of issue, of an annuity of one per annum payable on the first and each subsequent anniversary of such policy on which a premium falls due.....” (See Section 4 of the Standard Valuation Law, emphasis added.)
CALCULATION OF CRVM RESERVES WHEN DEATH BENEFITS ARE NOT LEVEL

Text

In the definition of the Commissioners’ Reserve Valuation Method, the Standard Valuation Law (Section 4) refers to the “net level annual premium on the nineteen-year premium whole life plan for insurance of the same amount....” The law does not define “the same amount” for cases when death benefits are not level. For policies issued after the operative date of Section 5-c of the Standard Nonforfeiture Law for Life Insurance (Section 5-c provides for the use of the 1980 CSO Table, among other things) “the same amount” is to be taken as the renewal nine-year arithmetic average, i.e., the arithmetic average of the death benefit at the beginning of each of policy years 2 through 10, inclusive.

Background Information

The Report of the Society of Actuaries Committee recommended this approach. Walter O. Menge in his paper Commissioners Reserve Valuation Method, RAIA XXXV (see p 277ff, especially p 283), defined an “equivalent level renewal amount” which has been accepted and still is the appropriate function for policies issued before the operative date of Section 5-c of the Standard Nonforfeiture Law for Life Insurance. The Society Committee indicated that the strongest factor that weighed in its conclusion was the effect on reserves for such plans as jumping juvenile. Menge noted the similarity between his definition of “equivalent level renewal amount” and the definition of “equivalent uniform amount” in Section 5 of the Standard Nonforfeiture Law for Life Insurance. In the same way, the function prescribed above is consistent with the “average amount of insurance” in Section 5-c of the Standard Nonforfeiture Law for Life Insurance. A principal reason for the change in the Standard Nonforfeiture Law was to simplify calculations, and this guideline will also have that result.
Appendix C  
Actuarial Guideline XVIII

CALCULATION OF CRVM RESERVES ON SEMI-CONTINUOUS, FULLY CONTINUOUS OR DISCOUNTED CONTINUOUS BASIS

Text

The Standard Valuation Law uses the “excess of (a) over (b)” in the definition of the modified net premiums in Section 4. If reserves are calculated on a basis other than curtate, i.e., using semi-continuous, fully continuous or discounted continuous functions, the excess of (a) over (b) may be calculated using the same basis (semi-continuous, etc.).

Background Information

The Report of the Society of Actuaries Committee recommended this approach. The excess of (a) over (b) is sometimes referred to as the initial expense allowance. Basing this expense allowance on curtate functions is conservative as this results in the smallest amount of expense allowance. Also, the expense allowance is the same regardless of which type of functions are used. On the other hand, the use of curtate functions when the basic calculation is based on other functions can result in complications in calculation. The difference in the resulting reserves does not justify the additional complication.
1980 CSO MORTALITY TABLE WITH TEN-YEAR SELECT MORTALITY FACTORS

Text

The Standard Valuation Law and the Standard Nonforfeiture Law for Life Insurance make reference to the Commissioners’ 1980 Standard Ordinary Mortality Table with Ten-Year Select Mortality Factors. The Ten-Year Select Mortality Factors referred to are those developed by the Society of Actuaries Special Committee to Recommend New Mortality tables for Valuation (see Report on p. 617ff and table of Ten-Year Select Mortality Factors on p. 669 of TSA XXXIII).

The NAIC model regulation regarding mortality tables independent of sex refers to certain specific tables which are blends of the male and female mortality rates of the 1980 CSO Table and specifies that these tables may be used with or without Ten-Year Select Mortality Factors. The Ten-Year Select Mortality Factors to be used with these blended tables are to be determined by use of the formula in the letter from Robert J. Johansen to Ted Becker reproduced on p. 457 of NAIC Proceedings 1984 Vol. I.

Background Information

The published report of a committee of the Society of Actuaries contains two sets of alternative select mortality factors. While that committee recommended that the alternative factors not be adopted, their publication has caused some confusion.
JOINT LIFE FUNCTIONS FOR 1980 CSO MORTALITY TABLE

Text

The tables of uniform seniority and the “Ultimate 1xx Tables” in Appendix 5 of the Report of the Society of Actuaries Committee on Specifications for Monetary Values - 1980 CSO Tables are acceptable for use in calculating reserves or nonforfeiture values for joint life policies on the 1980 CSO basis. These tables from Appendix 5 of the report are reproduced on the following pages of this Actuarial Guideline. These tables are numbered A5-1, A5-6 and A5-7 to coincide with the page numbers of those tables in Appendix 5 of the Society Committee report. (These are the only tables considered necessary for the purpose of this guideline.)

Other methods of calculating joint life functions may also be acceptable. In particular, it is acceptable to calculate “exact” joint life functions using published 1980 CSO mortality rates for the actual ages and genders of the lives to be insured.
Tables showing the deduction to be made from the age of the older of two lives in order to obtain the equivalent equal ages. The equivalent equal ages are then used to enter tables of functions derived from tables based on one male and one female of the same age.

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It is not appropriate to apply values from the FEMALE/FEMALE column so that a negative joint equal age results. In such situations equivalent equal age zero should be used.
# Appendix C

## 1980 CSO AND 1980 CET TABLES

### ULTIMATE 1XX TABLES

#### MALE/FEMALE - JOINT EQUAL AGES

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### ULTIMATE 1xx TABLES

#### MALE/FEMALE - JOINT EQUAL AGES

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<td>12,821,661,200</td>
<td>99</td>
<td>100</td>
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</tr>
</tbody>
</table>
Text

The Standard Valuation Law used the “excess of (a) over (b)” in the definition of the modified net premiums in Sec. 4. If the excess of (a) over (b) is negative, and the policy is issued on or after Jan. 1, 1987 the excess is to be taken as zero.

The Standard Valuation Law defines (a) as a net level premium, subject to a maximum. The net level premiums for the policy are a uniform percentage of the respective gross premiums such that the present value at issue of the net level premiums payable on and after the first anniversary is equal to the present value at issue of the benefits provided for by the policy after the first anniversary. The net level premium used in determining (a) is the net level premium payable on the first anniversary. The maximum for (a) is the net level premium on the 19-year premium whole life plan for a policy with level premiums issued at an age one year higher than the age at issue of the policy.

The value of (a) is to be calculated as defined in the Standard Valuation Law, even if the resulting reserves are not equal to reserves according to the full preliminary term method.

Background Information

The Report of the Society of Actuaries Committee on Specifications for Monetary Values—1980 CSO Tables recommended that a negative excess of (a) over (b) be taken as zero. Walter O. Menge in his paper Commissioners Reserve Valuation Method, RAIA XXXV (see pp. 260 and 261) pointed out the illogic of a negative excess of (a) over (b). A negative excess, if used, would result in CRVM reserves that are greater than net level premium reserves. This principle has been recognized since Menge wrote his paper, but some actuaries are not aware of the paper.

Defining the net level premiums as being a uniform percentage of the respective gross premiums is consistent with the definition in Menge’s paper. Since the denominator of (a) is the present value of an annuity commencing on the first anniversary, the logical value for (a) is the net level premium (as defined) payable on the first anniversary.

In his paper, Menge indicates that CRVM reserves are equal to full preliminary term reserves unless the value of (a) is the maximum defined in the Standard Valuation Law, or unless the excess of (a) over (b) is negative. Menge does not appear to have considered the case where the gross premium for the first policy year does not equal the gross premium for the second policy year. For such policies a literal application of the Standard Valuation Law does not result in full preliminary term reserves.
INTERPRETATION REGARDING NONFORFEITURE VALUES FOR POLICIES WITH INDETERMINATE PREMIUMS

Text

Indeterminate premium policies provide that premiums after issue will be determined by the insurer based on then current assumptions as to future experience. The policies also provide a schedule of maximum premiums which the premiums actually charged will not exceed.

The minimum nonforfeiture values for an indeterminate premium policy are the greater of those assuming that the gross premiums for the policy are (i) those according to the schedule of gross premiums based on current assumptions at issue and illustrated to prospective policyholders, or (ii) those according to the schedule of maximum gross premiums included in the policy:

Background Information

Indeterminate premium policies are a fairly recent development in life insurance. They can serve a legitimate function by enabling a nonparticipating policy to include a safety margin that need not be called upon unless it is needed. Indeterminate premiums are sometimes used to avoid deficiency reserve requirements. In general, regulators have not objected to this.

Section 6 of the Standard Nonforfeiture Law for Life Insurance refers to “any plan of life insurance which provides for future premium determination, the amounts of which are to be determined by the insurance company based on then estimates of future experience....” This is a direct reference to the types of life insurance policies commonly known as indeterminate premium plans (see “Detailed Analysis of Recommended Changes in the Standard Valuation Law and the Standard Nonforfeiture Law for Life Insurance; NAIC Proceedings - 1981 Vol. II, p. 831). The Standard Nonforfeiture Law for Life Insurance provides that minimum nonforfeiture values for such policies are to be computed by a method consistent with the principles of the Law as determined by regulations promulgated by the commissioner.

Section 5 and Section 5-c of the Standard Nonforfeiture Law for Life Insurance each provide that “the adjusted premiums for any policy shall be calculated on an annual basis and shall be....(a) uniform percentage of the respective premiums specified in the policy for each policy year...” Indeterminate premium policies provide for two amounts of premiums for each year: the actual premium to be charged and the maximum amount of the actual premium. This raises the question of which premium is to be used in setting adjusted premiums as a uniform percentage of the gross premiums.

The maximum premiums have the advantage that they are known at the time the policy is issued. However, use of maximum premiums to determine minimum values can lead to manipulation. A level premium whole life policy has a readily determined set of minimum values in accordance with the Standard Nonforfeiture Law for Life Insurance. If the policy has indeterminate premiums and the premiums illustrated to the customer (with proper disclosure of their indeterminate nature) are level for life, there should be no change in the minimum values. If the minimum values were determined by reference to the maximum premiums and not to the schedule of premiums on the current assumptions, introduction of maximum premiums that increase by duration would result in lower minimum values.

This guideline was written with policies other than universal life insurance in mind. However, it is possible to design a fixed premium universal life insurance policy to which this guideline would be applicable.
A variable life insurance separate account shall be deemed to have sufficient net investment income and readily marketable assets to meet anticipated obligations under policies funded by the account, as required by [statutory reference for state], if, and only if, it can be demonstrated to the satisfaction of the Commissioner that the sum of the market value of readily marketable assets in the account at the date of valuation, plus the anticipated net investment income for the calendar year following the date of valuation exceeds by at least 15% the anticipated death benefits, surrenders, withdrawals and other such obligations payable from current account values during the same period. For the purposes of this demonstration, readily marketable assets means cash or those investments which have readily ascertainable market value and which can be marketed before the close of the next business day; net investment income excludes capital gains or losses; and the value of the anticipated death benefits, surrenders, withdrawals and other such obligations payable during the calendar year following the date of the valuation shall not be estimated at less than 10% of the market value of the account assets at the date of valuation.

If a variable life insurance separate account is divided into separate series, portfolios or other investment subdivisions, each series, portfolio or investment subdivision shall comply with this subsection.
Minimum cash surrender values for variable life insurance policies shall be determined separately for the basic policy and any benefits and riders for which premiums are paid separately. The methods pertain to a basic policy and any benefits and riders for which premiums are not paid separately.

Minimum cash surrender values for variable life policies may be determined using option B (Retrospective Method), C (Prospective Method), or D (Maximum Charge Method).

A. Definitions

(1) “Valuation Rate” as used in this guideline means the higher of the Assumed Investment Rate (AIR) or guaranteed interest rate included in the policy, if any, otherwise the highest valuation interest rate allowed under the Standard Nonforfeiture Law.

(2) “Net Cash Surrender Value” means the maximum amount payable to the policyowner upon surrender.

(3) “Cash Surrender Value” means the Net Cash Surrender Value plus any amounts outstanding as policy loans.

(4) “Policy Value” means the amount to which separately identified interest credits and or investment return and mortality, expense, or other charges are made under a variable life insurance policy.

(5) “Accumulation Rate” means the net investment return and/or any interest credits applied towards the policy value.

B. Retrospective Method

The minimum cash surrender value (before adjustment for indebtedness and dividend credits) available on a valuation date shall be equal to the value using the Accumulation Rate through that date of the premiums paid minus the accumulation through that date of (i) the benefit charges, (ii) the averaged administrative expense charges for the first policy year and any insurance-increase years, (iii) actual administrative expense charges for other years, (iv) initial and additional acquisition expense charges not exceeding the initial or additional expense allowances, respectively, (v) any service charges actually made (excluding charges for cash surrender or election of a paid-up nonforfeiture benefit) and (vi) any deductions made for partial withdrawals; all accumulations being at the Accumulation Rate at which changes in policy values have been made unconditionally to the policy (or has been made conditionally, but for which the conditions have since been met), and minus any unamortized unused initial and additional expense allowance.

Accumulation for the premiums and for all charges referred to in items (i)-(vi) above shall be based on the Accumulation Rate for the applicable account(s) from and to such dates as are consistent with the manner in which such Accumulation Rate is credited in determining the policy value.

The benefit charges shall include the charges made for mortality and any charges made for riders or supplementary benefits for which premiums are not paid separately. If benefit charges are substantially level by duration and develop low or no cash values, then the Commissioner shall have the right to require higher cash values unless the insurer provides adequate justification that the cash values are appropriate in relation to the policy’s other characteristics.
The administrative expense charges shall include charges per premium payment, charges per dollar of premium paid, periodic charges per thousand dollars of insurance, periodic per policy charges, and any other charges permitted by the policy to be imposed without regard to the policyowner’s request for services. The averaged administrative expense charges for any year shall be those which would have been imposed in the year if the charge rate or rates for each transaction or period within the year had been equal to the arithmetic average of the corresponding charge rates which the policy states will be imposed in policy years through twenty in determining the policy value.

The initial acquisition expense charges shall be the excess of the expense charges, other than service charges, actually made in the first policy year over the averaged administrative expense charges for that year. Additional acquisition expense charges shall be the excess of the expense charges, other than service charges, actually made in an insurance-increase year over the averaged administrative expense charges for that year. An insurance-increase year shall be the year beginning on the date of increase in the amount of insurance by policyowner request (or by the terms of the policy).

Service charges shall include charges permitted by the policy to be imposed as a result of a policyowner’s request for a service by the insurer (such as the furnishing of future benefit illustrations) or of special transactions.

The initial expense allowance shall be the allowance provided by Items (ii), (iii), (iv) of Section 5, or by Items (ii) and (iii) of Section 5c(1), as applicable, of the Standard Nonforfeiture Law for Life Insurance, as amended in 1980, for a fixed premium, fixed benefit endowment policy with a face amount equal to the initial face amount of the variable life insurance policy, with level premiums paid annually until the highest attained age at which a premium may be paid under the variable life insurance policy, and maturing on the latest date permitted under the policy, if any, otherwise at the highest age in the valuation mortality table. The unused initial expense allowance shall be the excess, if any, of the initial expense allowance over the initial acquisition expense charges as defined above.

If the amount of insurance is subsequently increased upon request of the policyowner (or by the terms of the policy), an additional expense allowance and an unused additional expense allowance shall be determined on a basis consistent with the above and with Section 5c(5) of the Standard Nonforfeiture Law for Life Insurance, as amended in 1980, using the face amount and the latest maturity date permitted at that time under the policy.

The unamortized unused initial expense allowance during the policy year beginning on the policy anniversary at age $x + t$ (where “$x$” is the issue age) shall be the unused initial expense allowance multiplied by $\ddot{a}_{x+t}/\ddot{a}_x$ where $\ddot{a}_{x+t}$ and $\ddot{a}_x$ are present value of an annuity of one per year payable on policy anniversaries beginning at ages $x + t$ and $x$, respectively, and continuing until the highest attained age at which a premium may be paid under the policy, both on the morality guaranteed in the policy and the Valuation Rate for the policy. An unamortized unused additional expense allowance shall be the unused additional expense allowance multiplied by a similar ratio of annuities, with $\ddot{a}_x$ replaced by an annuity beginning on the date as of which the additional expense allowance was determined.

(Note: The drafters chose a whole life initial expense allowance for several reasons. Variable life insurance is generally considered a permanent life insurance plan and most companies encourage a premium level which will provide lifetime insurance protection. Every variable life insurance policy of which the drafters are aware has a “net level premium” that could be computed which would guarantee permanent protection using some suitable interest assumption. As a result, it is expected that most variable life insurance policies will be sold as permanent plans.

Traditional whole life insurance, which is accorded a permanent plan expense allowance by the Standard Nonforfeiture Law (SNFL), is much more flexible than is often realized. Premiums may be stopped with term coverage resulting, policy loans can result in “stop and go” premiums, or a vanishing premium arrangement can be effected, all without the permanent plan expense allowance being affected. The SNFL
does not require cash values for many forms of term insurance. All other permanent plans develop an
expense allowance greater than that for whole life insurance under the SNFL.

The alternative of basing the initial expense allowance on a policyowner’s “planned premium” was
considered but rejected as artificial and subject to substantial manipulation by agents and/or insurers.)

C. Prospective Method

The minimum cash surrender value (before adjustment for indebtedness and dividend credits) available
on a date as of which interest is credited to the policy shall be equal to \[(1) - (2) - (3) - (4)\] where:

(1) is the present value of all future benefits;

(2) is the present value of future adjusted premiums. The adjusted premiums are calculated as
described in Sections 5 and 5a or in Section 5c(1), as applicable, of the Standard
Nonforfeiture Law for Life Insurance, as amended in 1980. If Section 5c(1) is applicable,
the nonforfeiture net level premium is equal to the quantity \(PVFB/\alpha_x\), where \(PVFB\) is the
present value of all benefits at issue assuming future premiums are paid by the
policyowner and all guarantees contained in the policy or declared by the insurer, and
using the Valuation Rate.

\(\alpha_x\) is the present value of an annuity of one per year payable on policy
anniversaries beginning at age \(x\) and continuing until the highest attained age at which a
premium may be paid under the policy.

(3) is the present value of any quantities analogous to the nonforfeiture net level premium
which arise because of guarantees declared by the insurer after the issue date of the
policy. \(\alpha_x\) shall be replaced by an annuity beginning on the date as of which the
declaration became effective and payable until the end of the period covered by the
declaration.

(4) is the sum of any quantities analogous to (2) which arise because of structural changes in
the policy.

(Note: Structural changes are those changes which are separate from the automatic workings of the
policy. Such changes usually would be initiated by the policyowner and include changes in the
guaranteed benefits, changes in latest maturity date, or changes in allowable premium payment period.)

Future benefits are determined by (1) projecting the policy value, taking into account future premiums, if
any, and using the guaranteed interest rate, if any; otherwise, the lesser of the AIR, if any, or the highest
state approved nonforfeiture interest rate, and using the mortality, expense deductions, etc. contained in
the policy or declared by the insurer; and (2) taking into account any benefits guaranteed in the policy or
by declaration which do not depend on the policy value.

All present values shall be determined using (i) an interest rate (or rates) specified by the Standard
Nonforfeiture Law for Life Insurance, as amended in 1980, for policies issued in the same year and (ii)
the mortality rates specified by the Standard Nonforfeiture Law for Life Insurance, as amended in 1980,
for policies issued in the same year or contained in such other table as may be approved by the
Commissioner for this purpose.

(Note: The types of quantities included in (3) are increased current interest rate credits guaranteed for a
future period, decreased current mortality rate charges guaranteed for a future period, or decreased current
expense charges guaranteed for a future period.)
D. Maximum Charge Method

(1) Definitions: Wherever used in this Section, the terms have the respective meanings set forth or indicated in this paragraph.

(a) Policy Value is equal to gross premiums paid (excluding separate identified premiums for riders or supplementary benefits which are not credited to policy value) plus net investment income (which may be positive or negative and may vary based on policy loans) less the following as specified in the policy: (i) administrative charges (which may be taken in part from premiums and in part from policy value), (ii) acquisition and other charges, (iii) deferred acquisition and other charges, (iv) benefit charges, (v) service charges, (vi) partial withdrawals, and (vii) partial surrender charges.

(b) Benefit Charges made to the Policy Value are mortality charges made for life insurance on the insured person or persons and any charge made for riders and supplementary benefits.

(c) Service Charges made to the Policy Value are charges for transactional costs such as partial withdrawals, reallocations of policy values and benefit illustrations. Transactional charges shall not be assessed unless specifically permitted by law or regulation for transactions made under mandatory policy provisions.

(d) Administrative Charges is a per policy charge made regularly to the Policy Value (or deducted from premiums on scheduled premium policies) for the cost of administration. This charge may not exceed $5.00 per month in 1986. In subsequent years the limit for any new or in force policy shall be the product of $5.00 and the ratio (not to exceed 2.00) of (1) the Consumer Price Index (for all urban households) for the September preceding the year for which the determination is being made to (2) the Consumer Price Index for September 1986. The Commissioner may allow a higher charge upon an insurer demonstrating a justification.

(e) Acquisition and Other Charges are deducted from gross premiums before they are credited to Policy Value and/or made to the Policy Value. They may be expressed as a percentage of premium or a dollar amount per $1,000 of insurance or a dollar amount per premium payment or a per policy charge (other than the Administrative Charge). They do not include charges made as a reduction in investment return. These charges may vary by premium size, policy size and by policy year.

(f) Excess First Year Acquisition and Other Charges shall be the maximum excess of (A) over (B) based on the assumption that any premium (other than a single premium) payable in the first policy year is also payable during the entire premium paying period. (A) is the Acquisition and Other Charge made in the first policy year and (B) is the arithmetic average of the corresponding charges which the policy states would be made in policy years two through twenty.

(g) Excess Acquisition and Other Charges for a Face Amount Increase shall be the maximum excess of (A) over (B) based on the assumption that the net level whole life annual premium for the increase (as defined in (j) below) applies throughout the remaining premium paying period. (A) is the Acquisition and Other Charge for the increase, and (B) is the arithmetic average of the
corresponding charges which the policy states would be made in the nineteen policy years following the increase.

(h) Net Investment Return is the actual amount credited to Policy Value net of investment expenses and/or other charges made as a reduction in investment return.

(i) The net level whole life annual premium at issue is based on the assumption of level insurance and level annual premium for life, the mortality table rate used to calculate the maximum mortality charges and an interest rate based on the higher of 4% or that specified in the policy.

(j) The net level whole life annual premium for an increase in the face amount of insurance shall be determined as of the date of the increases as though such increase were a separate policy under (i) above. Only increases in the face amount requested by the policyowner and increases in the face amount pursuant to the terms of the policy (e.g. an option to purchase or a cost of living increase) shall give rise to such a premium and the associated Excess Acquisition and Other Charges for a Face Amount Increase. Increases for this purpose shall not include increases in face amount resulting from a change in the death benefit option or changes in death benefit pursuant to policy terms that do not affect the face amount. Increases for this purpose shall be reduced by the amounts of any earlier decrease by reason of a partial withdrawal, but not a decrease resulting from a change in the death benefit option.

(k) Surrender Charge is a deferred charge made to the Policy Value in the event of a full or partial surrender of the policy, reduction in the face amount of insurance or premium, or a lapse.

(l) Cash Surrender Value is the Policy Value less any Surrender Charge, before reduction for outstanding loans or other amounts due under the policy.

(m) Deferred Acquisition and Other Charges are Acquisition and Other Charges deducted from the Policy Value after the first policy year.

(2) Cash Surrender Values determined in accordance with this subparagraph shall meet minimum requirements.

(a) If Acquisition and Other Charges do not exceed the sum of:

(1) 90% of premiums received up to the net level whole life annual premium at issue (regardless of when received).

(2) 10% of all other premiums received.

(3) 90% of the net level whole life annual premium for increases in the face amount of insurance as defined in 1(j).

(4) $10 per $1,000 of initial face amount in the first policy year.

(5) $1 per $1,000 of face amount in subsequent policy years.

(6) $10 per $1,000 of any increase in the face amount of insurance other than an increase resulting from a change in the death benefit option. Increases
Appendix C

up to the amount of earlier decreases are included here but not in (3) above.

(7) $200 per policy in the first year.

(b) A surrender charge may be established provided that the initial surrender charge together with the actual Acquisition and Other Charges made in the first policy year (and on premiums up to the net level whole life annual premium if received after the first year) do not exceed the sum of (1), (2) in the first year, (4) and (7) in (a) above. Additional surrender charges may be established after issue in connection with an increase in face amount provided that any such additional surrender charge and any Acquisition and Other Charges made in connection with such increase do not exceed the sum of (3) and (6) in (a) above.

(c) A Deferred Acquisition and Other Charge may be charged against the Policy Value in any policy year after the first, such that the total of all such charges imposed to date plus the surrender charge for that year does not exceed the maximum initial surrender charge. The Deferred Acquisition and Other Charges in any one year may not exceed the maximum allowable surrender charge for that year. Similar Deferred Acquisition and Other Charges may be imposed with respect to an increase in face amount.

(d) The maximum allowable surrender charge for any year shall be the maximum initial surrender charge multiplied by $\bar{a}_{x+t}/\bar{a}_x$, where “x” is the issue age and “t” is the number of years since issue. Similar maximums shall be determined with respect to any additional surrender charges, with x and t based on the date of increase.

(Note: The minimum cash value methods B, C, or D are not intended to prohibit the current practice of allowing the imposition of additional surrender charges defined as follows. In the case of combination general account and separate account variable life products, additions or amounts derived from more favorable interest, mortality, and expense than those guaranteed in the policy on the general account fund and credited within 12 months prior to surrender may be subject to forfeiture upon surrender.)

E. Minimum Paid-Up Nonforfeiture Benefits

If a variable life insurance policy provides for the optional election of a paid-up nonforfeiture benefit, it shall be such that its present value shall be at least equal to the cash surrender value provided by the policy on the effective date of the election. The present value shall be based on mortality and interest standards at least as favorable to the policyowner as (1) the mortality and interest basis, if any, specified in the policy for determining the policy value, or (2) the mortality and interest standards permitted for paid-up nonforfeiture benefits by the Standard Nonforfeiture Law for Life Insurance, as amended in 1980. In lieu of the paid-up nonforfeiture benefit, the insurer may substitute, upon proper request not later than sixty days after the due date of the premium in default, an actuarially equivalent alternative paid-up nonforfeiture benefit which provides a greater amount or longer period of death benefits, or, if applicable, a greater amount or earlier payment of endowment benefits.

(Note: It is possible that policies will have secondary guarantees. Such guarantees should be taken into consideration when computing minimum paid-up nonforfeiture benefits.)

Ever since the adoption of the original Standard Nonforfeiture Law (SNFL) in 1942, provision has been made for nonforfeiture calculations on the basis of substandard mortality. (See Sections 5.5a. and 5c, Paragraph 8(e) of SNFL.)
While this provision has been used infrequently in the past, it is anticipated the substandard mortality will be more frequently utilized in variable life insurance, given its flexible nature, to reflect the mortality classification assigned to the policy by the insurer.

A charge may be made at the surrender of the policy provided that the result after the deduction of the charge is not less than the minimum cash surrender value required by this guideline.)
CALCULATION OF MINIMUM RESERVES AND MINIMUM NONFORFEITURE VALUES FOR POLICIES WITH GUARANTEED INCREASING DEATH BENEFITS BASED ON AN INDEX

A. Valuation - Text

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the value of the minimum reserve at any time shall be based on the maximum valuation interest rate for the year of issue and an acceptable mortality table for life insurance statutory reserves and based on the death benefit and premium pattern adjusted as provided in the policy by reasonable annual increases based on the index. The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. The assumption as to what is a reasonable annual increase in death benefits based on the index must not be less than the maximum valuation interest rate for the year of issue less:

1.  2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%.
2.  1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.
3.  1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.
4.  1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.
5.  1.0% For all other plans.

The term “annual and non-cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index without carry forward of excess index increases.

The term “annual and cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index with carry forward of excess index increases.

In no event shall the assumption as to an annual increase based on the index be less than 1.0%.

This guideline for valuation shall be effective immediately for policies issued on or after January 1, 1991.

B. Nonforfeiture – Text

The threshold amount shall be $10,000 until December 31, 2009. For years beginning after December 31, 2009, the threshold amount for a calendar year shall be the product of $10,000 and the ratio of 1) the index for June of the prior year to 2) 136.0 (the index as of June 30, 1991), rounded to the nearest $25. If this calculation would result in an increase in the threshold amount of less than $500, the unadjusted
threshold amount from the prior year shall continue in effect for the next calendar year. In no calendar year shall the increase in threshold amount exceed 5% of the prior calendar year threshold amount.

The index used to determine the threshold amount for years beginning after December 31, 2009, shall be the Consumer Price Index for All Urban Consumers (CPI-U) as of June 30 of that year. If this index is no longer available, another index which, in the actuary’s opinion, reflects the change in general consumer prices for the year should be substituted.

I. FOR POLICIES WHERE ANY DEATH BENEFIT FOR ANY POLICY YEAR WOULD EXCEED THE THRESHOLD AMOUNT EVEN IN ABSENCE OF ANY ANNUAL INCREASES BASED ON THE INDEX

For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the value of the minimum nonforfeiture benefit at any time shall be based on the maximum nonforfeiture interest rate for the year of issue and an acceptable mortality table for life insurance nonforfeiture and based on the death benefit and premium pattern adjusted as provided in the policy by reasonable annual increases based on the index. The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. The assumption as to what is a reasonable annual increase in death benefits based on the index must not be less than the maximum valuation interest rate for the year of issue less:

1. 2.0% If the annual increase is limited to an annual and non-cumulative maximum of 0% through 5.0%.
2. 1.5% If the annual increase is limited to an annual and cumulative maximum of 0% through 5.0%.
3. 1.5% If the annual increase is limited to an annual and non-cumulative maximum of 5.01% through 10.0%.
4. 1.25% If the annual increase is limited to an annual and cumulative maximum of 5.01% through 10.0%.
5. 1.0% For all other plans.

The term “annual and non-cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index without carry forward of excess index increases.

The term “annual and cumulative maximum” refers to a maximum where each annual increase is limited to the lower of the maximum or the increase in the index with carry forward of excess index increases.

In no event shall the assumption as to an annual increase based on the index be less than 1.0%.

II. FOR POLICIES WHERE ANY DEATH BENEFIT FOR ANY POLICY YEAR WOULD NOT EXCEED THE THRESHOLD AMOUNT IN ABSENCE OF ANY ANNUAL INCREASES BASED ON THE INDEX
For a policy where premiums are fixed in amount at issue which provides for whole life insurance with the amount of death benefit adjusted periodically with the Consumer Price Index or another cost of living index, the unadjusted value of the minimum nonforfeiture benefit at any time shall be based on a level death benefit, an acceptable mortality table for life insurance nonforfeiture and a nonforfeiture interest rate equal to:

1. 4.5% If the annual increase based on the index is limited to a maximum of 0% through 5.0%.
2. 4.25% If the annual increase based on the index is limited to a maximum of 5.01% through 10.0%.
3. 4.0% For all other plans.

The present value of future benefits component shall be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit. If the policy provides for future premiums and such premiums are also adjusted periodically with the Consumer Price Index or another cost of living index, the present value of future premiums component shall likewise be further adjusted each year by the ratio of the then current amount of death benefit to the initially projected amount of death benefit.

For purposes of this guideline multiple policies on a single life shall be aggregated and only those policies aggregating not more than $10,000 (or the threshold amount\(^1\) after December 31, 2009), shall be considered under B.II.

This guideline for nonforfeiture shall be effective immediately for policies issued on or after January 1, 1991.

**BACKGROUND**

A number of companies are marketing individual life insurance policies with guaranteed increasing death benefits tied in to a consumer price index or another cost of living index and are for low initial amounts of insurance sold through funeral directors to provide for burial expenses. Some of the policies provide for graded death benefits such as the return of premium with or without interest for the early policy years or for a fixed scheduled increase in death benefits prior to the operation of the index. In some cases there is a maximum on the increase for any year. The vast majority of such policies are single premium policies but some are annual premium policies (generally limited payment). The annual premium may or may not be subject to adjustment with the index.

Since the changes in the index are not known at issue, but from past experience, increases within a given range can be expected with a high probability, it is necessary to assume some increases and then to continually adjust the present value of future benefits component and, if appropriate, the present value of future premiums component in the reserve and nonforfeiture calculation.

Theoretically the same assumed increases in the death benefits should be used for both valuation and nonforfeiture. This guideline so provides for policies where the amount of death benefit in any given policy year would exceed $10,000 (or the threshold amount\(^1\) after December 31, 2009), even if there were no increases based on the index. For practical purposes this may mean that such policies are not marketable for higher amounts as it is most likely that such policies will not qualify under the IRS Section

\(^1\) In 2010, the actuarial guideline was modified to substitute a threshold amount for 10,000, such threshold being increased by the change in the CPI-U, the CPI for All Urban Consumers.
7702. The cash value accumulation test to qualify thereunder requires a minimum interest rate of 4% and an assumed level amount of death benefits.

In the case of policies for an initial amount of insurance of $5,000 or less, the IRS rules provide an exception to the prohibition of assuming increasing death benefits. However, since many of the policies for very low amounts of initial face amount of insurance would require relatively high expenses if underwritten, many of the policies are issued with simplified underwriting or on a guaranteed issue basis with lower amounts of death benefits in the early policy years, some of the resulting annual increases are such as would disqualify many of the policies for the exception. Therefore it is recommended that policies for low amounts of insurance be allowed to qualify under the cash value accumulation test by permitting the nonforfeiture values to be based on a level death benefit and 4% or higher interest and requiring such values to be updated as increases based on the index take place. The amount in this guideline is set at $10,000 (or the threshold amount after December 31, 2009), to allow for future adjustments and for different patterns of benefits for low amounts.

For single premium policies, the value of nonforfeiture benefits based on a level death benefit and a net assumed nonforfeiture interest rate equal to the maximum nonforfeiture interest rate less an assumed increase based on the index and such factors then adjusted by the projected increases will approximate factors based on assumed increases and the maximum nonforfeiture interest rate. However, the net interest rate is likely to be less than 4%. Thus the procedure of assuming a level death benefit and a net assumed rate of not less than 4% for policies of low amounts of insurance is apt to produce lower cash values than the procedure for large amounts of insurance. Such lower values can be justified based upon the fact that the highly specialized market is prearranged funeral expenses for very small amounts of insurance per policy.

To emphasize the qualification with the IRS rules for the very low amounts of insurance, the nonforfeiture guideline for small amount policies is stated in terms of the net rate, a level death benefit and continual adjustment.

For solvency purposes, reserves should be conservative. The same rules apply for reserve regardless of the size of the policy. That is, lower reserves are not permitted for policies with very low amounts of insurance per policy.

Paragraph 5c(3) of the Model Standard Nonforfeiture Law states that unscheduled changes do not need to be taken into account until the time of the change. The changes guaranteed according to an index are a hybrid, i.e. the changes are scheduled but the amount of the change is not known until the index is determined. Thus the changes must be recognized at issue. This guideline is a hybrid with increases assumed at issue either explicitly or implicitly but with further adjustments made at the time the increase based on the index is determined.
ELECTION OF OPERATIVE DATES UNDER STANDARD VALUATION LAW AND STANDARD NONFORFEITURE LAW

Preamble

The model Standard Nonforfeiture Law for Life Insurance contains Section 5-C, which defines new mortality and interest rate components to be used as the minimum standard for nonforfeiture values for life insurance policies. The Commissioners 1980 Standard Ordinary Table, or that table with Ten-Year Select Factors, is identified in Section 5-C as the applicable mortality table component for ordinary life insurance policies (although there is a provision for other alternate mortality tables to be permitted by regulation). Section 5-C also incorporates “dynamic” interest rates, as the applicable interest rate component. In addition, Section 5-C contains a new and different formula to be used in computing the adjusted premiums that define minimum nonforfeiture values.

Section 5-C contains a mandatory operative date, but there is also language permitting companies to elect an early operative date under certain conditions.

The model Standard Valuation law contains a cross reference to operative date for Section 5-C of the Standard Nonforfeiture Law for Life Insurance. After such operative date, there are mortality and interest rate components defined for use as the minimum standard for computing reserves. The Commissioners 1980 Standard Ordinary Table, or that table with Ten-Year Select Factors, is identified as the applicable mortality table component for ordinary life insurance policies (although there is a provision for other alternate mortality tables to be permitted by regulation). “Dynamic” interest rates determine the applicable interest rate component, but a lower maximum interest rate is defined for reserves than for nonforfeiture values.

Generally, the applicable mortality rates are lower and the applicable interest rates higher after the operative date. Thus, the reserves defined under the minimum standard would be lower for policies issued on or after the operative date.

Text

Under no circumstances can an insurance company elect an operative date for the purpose of Section 5-C of the Standard Nonforfeiture Law for Life Insurance, if such operative date would be in a calendar year prior to the calendar year in which that company furnished written notice of election of an operative date under that law.

Background Material

The purpose of this actuarial guideline is to ensure consistency and provide guidance in the election of this operative date.

Historically, insurance companies have been allowed to elect early operative dates so as to pass along the benefits of improved mortality rates and current interest rates to policyholders who purchase new life insurance policies. These new policies would typically have lower nonforfeiture values and would require lower reserves, and net premiums would be lower also. The expectation is that the lower net premiums might allow the company to reconsider its gross premium rates for these new policies issued after the operative date, and in many cases to lower the new gross premium rates.
A second reason for allowing the election of an early operative date would be to allow insurance companies and state insurance departments more time to prepare and review new life insurance policies, which are to be introduced into the marketplace. If every life insurance policy had to be changed over on the same mandatory operative date, it would be a great burden on the resources of all the parties involved.
ACCELERATED BENEFITS

PURPOSE

This guideline is designed to cover the actuarial aspects of accelerated benefits. Three general categories of accelerated benefits are covered:

I) non-discounted acceleration of benefits

II) actuarially discounted acceleration of benefits

III) interest accrual approach to financing acceleration of benefits

In addition, there is a separate section to cover the special considerations for a policy lien approach, which is Section IV.

General considerations which apply to any method of determining accelerated benefits are given in Section V.

I. NON-DISCOUNTED ACCELERATION OF BENEFITS

A. Description

The type of plans considered in this subsection are those which provide for a defined event triggering one time acceleration of some or all of the death benefit of the base contract or rider, in such a way that every dollar of acceleration has a non-discounted matching reduction in the amount payable on death. These plans have been available in four forms, via

1. A contract integrating the acceleration feature with other, more traditional, features;

2. A rider attached to a regular contract at time of issue, to provide acceleration;

3. A rider, as in (2), but which may be attached to inforce contracts of the same company; or

4. A policy acting similar to the rider in (3) above, but for which the acceleration is applicable to inforce contract of other companies.

B. Reserves

1. Reserving Approach

Payment of benefits earlier than death itself is an early payment rather than a different payment. The basic reserve structure and requirements for regular life insurance need not be disturbed. Therefore, the CRVM methodology is acceptable, as is any other reserving methodology allowable for life insurance when determining the reserves needed for policies with an accelerated benefit or when determining the reserves for the accelerated benefit by itself.
2. **General Consideration**

A reserve formula should consider all relevant factors.

Approximations to develop a single decrement table which utilize all relevant factors except for voluntary termination rates are acceptable for policies and riders subject to this subsection provided it can be demonstrated that the approximations used produce essentially similar reserves, conservative reserves, or immaterial reserves. The calculations should take into account the reduction in life insurance benefits due to prior acceleration. However, in no event shall the reserves for the accelerated benefit and the life insurance benefit when taken together be less than the reserves for the life insurance benefit assuming no acceleration feature prior to payment of any accelerated benefits.

In the development and calculation of reserves for policies and riders subject to this subsection, due regard shall be given to the applicable policy provisions, marketing methods, administrative procedures and all other considerations which have an impact on projected claims costs, including, but not limited to the following:

a. Definition of acceleration events,

b. Premium waiver provision,

c. Marketing method,

d. Underwriting procedures,

e. Delay in eligibility for benefit,

f. Maximum benefit,

g. Optional nature of benefit, and/or

h. Guaranteed insurability options.

II. **ACTUARILY DISCOUNTED ACCELERATION OF BENEFIT**

A. **Description**

The products that are allowable under this type of approach generally provide for an acceleration of the death benefit payable under a life insurance policy, with an appropriate actuarial adjustment in the amount of money paid to the policyholder that represents the amount of money foregone by the Company by paying out the death benefit early. These products have no additional premium payable. This product can be made available at issue of the contract or after issue of the contract. It can either be a separate rider or part of the integrated policy. The interest rate or interest rate methodology used for discounting must be specified in the contract or rider or in the actuarial memorandum.

B. **Reserves**

The application of standard valuation law and CRVM reserves is appropriate for these policies. No additional reserves need be held as long as the actuary is convinced that the method used to discount the death benefit reflects sound actuarial principles.
If the actuary is convinced that the discounting procedure does not appropriately reflect these conditions, he or she should determine a reserve such that reserves are adequate for the life insurance benefits based on aggregates. There is nothing in this benefit design that changes that equation.

III. INTEREST ACCRUAL APPROACH TO FINANCING ACCELERATION OF BENEFITS

A. Description

Under this approach, the insurer accrues an interest charge on the accelerated benefit to account for lost investment income from the date of acceleration to the date of death. The interest may be accrued until death or may be required to be paid in cash periodically, or may be offset against the policy’s remaining death benefit.

1. Alternative methods of including an interest accrual option:
   
a. A benefit of this type may be provided either as an integral part of a life insurance policy or as a rider to a life insurance policy.

b. If offered as a rider to a life insurance policy, such rider may be attached to either a new policy or to an existing policy.

2. Alternative Benefit Designs using this option: The rider or policy form should specify whether interest accruing on prior accelerated benefit payment needs to be paid in cash or whether additional accelerated benefit payments will be made to cover such interest accruals as they become due. Either approach is equally acceptable.

B. Interest Accrual Rate

1. The rider or policy form or the actuarial memorandum should specify the method used to determine the rate(s) of interest to be charged.

2. The specification of the method should be clear and unambiguous.

3. The method used for determining the interest rate should be included in the Actuarial memorandum.

C. Reserves

1. Prior to the occurrence of an event qualifying the policy for accelerated benefits, minimum statutory reserves for policies containing interest accrual provisions are the same as for policies with identical death benefits that do not contain interest accrued lien provisions, provided that the method of determining the interest rate to be charged, as specified in the rider or policy provisions or actuarial memorandum, results in an interest rate at least equal to the valuation interest rate applicable to the policy. If such is not the case, an extra reserve may be necessary on such policies, if it is determined that the aggregate reserves are not good and sufficient.

2. Following the occurrence of a qualifying event, accrued interest is an asset of the company for statutory reporting purposes. However, the valuation actuary should make certain that reserves in the aggregate are adequate to assure that such aggregate accrued interest is provided for. This will assure that such accrued
interest assets can be held as admitted assets. The insurer’s valuation actuary may voluntarily increase the statutory reserve liability on each such policy in order to eliminate the need to non-admit a portion of the accrued interest policy lien or policy loan.

IV. BENEFIT PAYMENT LIENS

This section deals specifically with benefit payment liens and their effect on future policy premiums and benefits.

A. The presence of a lien against the policy does not require a pro-rata reduction in the policy premiums or other values.

B. Amount of lien computed as of the date of death may be deducted from the death benefit.

C. Access to non-forfeiture benefits upon surrender or through future policy loans may be restricted to any excess of the cash surrender value over the sum of any outstanding loans and the lien.

D. If the lien approach is used and RPU is available as a non-forfeiture benefit, the amount of RPU may be calculated as if no lien existed and the lien may continue to apply, provided that the lien continues to satisfy any percentage and dollar maximums and minimums specified in the contract. Alternatively, RPU may be made unavailable while the lien exists, provided an ETI benefit is available. Alternatively, the excess, if any, of the cash surrender value over the sum of outstanding loans and the lien may be applied in calculating the amount of the RPU, provided an ETI benefit is available. If the choice of methods is not left as an option to be the policyholder, the rider or policy form should specify which method will apply.

E. If the lien approach is used an ETI is available as a non-forfeiture benefit, the period of ETI may be calculated as if no lien existed and the lien may continue to apply, provided that the lien continues to satisfy any percentage and dollar maximums and minimums specified in the contract.

F. If the lien approach is used, any accelerated death benefit payment may first be applied toward repaying the portion of any outstanding policy loans which causes the sum of the accelerated death benefit and policy loans to exceed the cash value. Alternatively, outstanding policy loans may be retained and the lien that would otherwise be allowed may be reduced by any outstanding policy loans at the time of acceleration. If the choice of methods is not left as an option to the policyholder, the rider or policy form should specify which method will apply.

G. The rider or policy form accelerated benefit lien provisions may specify that the existence of a benefit lien will not prevent termination of the policy in accordance with the regular policy termination provisions.

H. If a policy terminates while subject to a lien, the insurer shall extinguish the lien without further recourse to the policyholder unless the policy or rider clearly indicates otherwise. In the event that the policy is reinstated, the lien may also be reinstated with interest accrued as if the policy had never terminated.

I. The policyholder should have the option of paying all or part of any premium or accrued interest that would be capitalized under the terms of the rider or policy provisions in cash,
as well as the option of repaying all or part of any lien in cash, in order to prevent the lien from causing the policy to terminate.

V. GENERAL CONSIDERATIONS

The items below should be considered, where applicable, for all types of accelerated benefits:

A. The rider or policy form should specify whether any premium becoming due after the initial accelerated benefit payment is established needs to be paid in cash or whether additional accelerated benefit payment will be made to cover such premiums as they become due. Either approach is equally acceptable.

B. The rider or policy form may specify any percentage and dollar minimum and maximum payments that may be accelerated. Any dollar or percentage minimums or maximums is equally acceptable. If no maximum is specified, it will be assumed to be 100% of the death benefit.

C. The accelerated benefit may include a reasonable expense charge for administrative expenses and risks assumed by the company. If the available amount of the initial accelerated benefit is less than the maximum allowed, the rider or policy form should specify how such initial amount will be determined.

D. The rider or policy form should specify the actions required, if any, to prevent policy termination if premium or interest expected to be capitalized would result in a total accelerated benefit payment exceeding the percentage or dollar maximum amount specified in the rider or policy form. Any such excess may be required to be paid in cash within an appropriate grace period in order to prevent policy termination. The rider or policy form may also specify that future premiums or interest becoming due must be paid in cash. If not specifically addressed, the rider or policy should remain in force and be administered with no change from the premium or interest requirement that existed immediately prior to the time at which the maximum was reached and the accelerated benefit would not be increased beyond the maximum specified in the rider or policy form.

E. The rider or policy form may specify whether the accelerated benefit provision would apply to the original base insurance policy death benefit or the current insurance policy death benefit. If not specifically addressed, the rider or policy form should be administered as if maximums are automatically increased, but not automatically decreased.

F. The rider or policy form may specify that an accelerated benefit is not available unless established prior to the policyholder’s election of or lapse to ETI or RPU. If not specifically addressed, the rider or policy forms should be administered to provide an accelerated benefit after election of or lapse to ETI or RPU.

G. The rider or policy form may specify that an accelerated benefit is not available if the policy has an irrevocable beneficiary or is assigned when accelerated benefits are initially claimed. Alternatively, the irrevocable beneficiary or assignee must provide a signed acknowledgement of concurrence for payout. The rider or policy form may specify that the policy may not be assigned (except to the insurer) after an accelerated benefit has been paid.
Background

Many of the major writers of group long-term disability income insurance have included survivor benefits in such contracts. Provisions related to the survivor benefit include minimum disability periods, benefit amounts defined in terms of a number of months of disability benefits and a specified percentage of the monthly disability benefit.

This benefit is sometimes overlooked in the valuation process or ignored as being trivial in amount.


Text

Claim reserves for survivor income benefits contained in group long-term disability contracts must be established based on the design of the survivor income benefit including the minimum period of disability before the spouse of a disabled person becomes eligible for a survivor income benefit and the amount of the benefit. A suitable approximation to the sum of the reserves for the basic disability benefit and the reserve for the survivor income benefit can be calculated by computing the reserve for the basic disability at an interest rate less than the maximum valuation interest rate.

Before any approximation can be accepted, rigorous testing of the approximation to the combined reserves for both the basic disability claim and the survivor income benefit must be performed. Tests indicated that basic disability reserves and survivor income benefit based on a 12-month disability requirement and a maximum survivor income benefit duration of 24 months with a survivor income benefit of .667 of the disability income with all reserves based on a valuation interest rate of 5.5% can be adequately approximated by basic disability reserves alone but calculated at a 3.5% valuation interest rate.
GUIDELINE CONCERNING RESERVES OF COMPANIES IN REHABILITATION

Preamble

The life insurance and annuity contracts of life insurance companies can be restructured by court order in rehabilitation proceedings. The contract restructuring may take the form of reduction in account values and/or guaranteed interest crediting premiums. Typically, the court order imposes restrictions on surrender of the contract while the company is in rehabilitation. These restrictions can include bans on surrenders while a rehabilitation plan is being developed and temporary limitations on the cash that can be obtained upon surrender. These restrictions are intended to prevent en masse surrenders while the company faces liquidity problems.

Several issues have arisen as to the interpretation of the Standard Valuation Law in these circumstances. The issues relate to the interpretation of the Commissioners’ Reserve Valuation Method (CRVM) and the Commissioners’ Annuity Reserve Valuation Method (CARVM), the determination of the guaranteed nonforfeiture benefits provided in the restructured contract and identification of the issue date of the contract after restructuring.

The Standard Valuation Law does not specifically address minimum reserve requirements after a contract has been restructured by court order. The minimum reserve requirements should be interpreted in the context of court-ordered contract restructuring to result in the most appropriate reserves under the particular circumstances. In general, this should be left to the regulators to determine.

Guideline

The phrase “future guaranteed benefits, including guaranteed nonforfeiture benefits,” as used in CARVM, includes the cash surrender values based on contractual guarantees after reduction for any surrender charges available under the contract. In general, the value of future guaranteed benefits under CARVM may not be reduced by contingent surrender charges which may not be available upon cash surrender. See Guideline Covering the Commissioners’ Annuity Reserve Valuation Method (CARVM) (1985).

Whether or not a court-imposed temporary restriction on the availability of cash on surrender is taken into account under CARVM depends upon whether the rehabilitation plan specifies that the restriction is a reduction in the guaranteed nonforfeiture benefits in the restructured contracts. If the rehabilitation plan imposes a distinct temporary charge to ensure liquidity as opposed to changing common surrender charges that are historically used to determining nonforfeiture benefits, the temporary charges will not reduce guaranteed nonforfeiture benefits for purposes of CARVM.

A similar rule applies for purposes of reporting those reserves on life insurance contracts entitled “For surrender values in excess of reserves otherwise required.”

For life insurance contracts, CRVM does not dictate that a particular method must be applied after a contract has been restructured. In the case of policies providing for a varying amount of insurance or requiring the payment of varying premiums, reserves are calculated by a method consistent with CRVM applicable to policies providing for a uniform amount of insurance and requiring the payment of uniform premiums.

A method consistent with CRVM adopted for purposes of a rehabilitation program should consider the valuation bases and expense allowance prior to restructuring as well as after restructuring. Depending upon the types of changes to the restructured contract, it may or may not be appropriate to take into account the guaranteed benefits and premium structure prior to restructuring.
The issue date for purposes of determining the applicable mortality tables and interest rates also depends on the circumstances. For example, it may be appropriate to treat annuity contracts as newly issued so that reserves are required to be recomputed using more current discount rates. However, in the same rehabilitation plan it may be inappropriate to treat a restructured level premium whole life contract as newly issued. Accordingly, whether a contract is treated as having a new issue date after contract restructuring depends upon the terms of the rehabilitation plan and the restructured contracts. In general, contracts are not treated as newly issued unless the rehabilitation plan or state filing for the restructured contracts so provides.

Similarly, the appropriate CRVM expense allowance will depend upon the terms and the intent of the restructuring and rehabilitation plan. Depending upon the types of changes to the restructured contract, it may be appropriate to carry forward an unamortized expense allowance based on original policy date. In other cases, a new unamortized expense allowance would be calculated as of the restructure date. In general, a new unamortized expense allowance is not calculated unless the rehabilitation plan or the state filing for the restructured contract so provides.
GUIDELINE FOR THE APPLICATION OF PLAN TYPE TO GUARANTEED INTEREST CONTRACTS (GICS) WITH BENEFIT RESPONSIVE PAYMENT PROVISIONS USED TO FUND EMPLOYEE BENEFIT PLANS.

Background Material

Guaranteed Interest Contracts (GICs) that are used to fund employee benefit plans often times contain a provision that allows individual participants to voluntarily move funds on a book value basis to other investment opportunities. These contracts also allow for the withdrawal of funds on a book value basis to provide employee benefits such as a death benefit to a surviving beneficiary, disability benefits and benefits paid upon bona fide termination of employment. In the situations described above, the individual participant is to be distinguished from the policyholder. Typical contractual language is as follows:

1. Withdrawal for Redirection of Investments - Subject to the provisions of Subsection above, the contract owner shall direct the withdrawal and transfer to the contract owner of the pro rata amounts from the accumulation accounts for the purpose of redirecting an employee investment to an equity fund in accordance with the provision of the Plan.

2. Withdrawal for Plan Benefit Payments - Subject to the provisions of Subsection above, the contract owner shall direct the withdrawal and transfer to the contract owner of the pro rata amounts from the accumulation account due to distribution made to participants (or to their beneficiaries, in case of the participant’s death) under the Plan.

Both examples of contractual language make reference to the “provisions of the Plan.” Plan provisions reduce the disintermediation (C-3) risk, from the insurance company standpoint, associated with GICs. For example, plan provisions may restrict the opportunity for the 401 (k) plan participant to move funds from the GIC option to a competing “guarantee of principal” option within the plan.

The Standard Valuation Law utilizes a concept known as Plan Type to distinguish between different levels of voluntary withdrawal rights by policyholders. Voluntary withdrawal rights are contractual policyholder rights which may be exercised at the option of the policyholder and do not include such items as scheduled contractual payouts or payouts upon termination. The greater the level of voluntary withdrawal right afforded to the policyholder, the more conservative is the resulting valuation interest rate. Plan Types are designated in the Standard Valuation Law as with Plan Type A, Plan Type B or Plan Type C and are defined as follows:

1. Plan Type A is a plan under which the policyholder may not withdraw funds, or may withdraw funds at any time but only (a) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, (b) without such an adjustment but in installments over five years or more, or (c) as an immediate life annuity.

2. Plan Type B is a plan under which the policyholder may not withdraw funds before expiration of the interest rate guarantee, or may withdraw funds before such expiration but only (a) with an adjustment to reflect changes in interest rate or assets values since receipt of the funds by the insurance company, or (b) without such an adjustment but in installments over five years or more. At the end of the interest rate guarantee, funds may be withdrawn without such adjustment in a single sum or installments over less than five years.
Plan Type C is a plan under which the policyholder may withdraw funds before expiration of the interest rate guarantee in a single sum or installments over less than five years either (a) without adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (b) subject only to a fixed surrender charge stipulated in the contract as a percentage of the funds.

Text

For purposes of the application of the Standard Valuation Law to Guaranteed Interest Contracts (GICs) with benefit responsive provisions, the withdrawal of funds at book value for the purpose of redirecting or withdrawing an employee investment shall be considered a withdrawal by the policyholder unless the underlying plan or GIC contain written provisions which are designed to reduce the C-3 risk to the insurance company. As an example, a provision which meets this criteria would include both the following:

1. No direct transfer to competing funds, whether such funds are alternate funds of the insurance company or not. This provision prohibits direct transfer of funds from the GIC option to a competing plan option that offers either a guarantee of principal or to an option in which the risk of loss of principal is small such as a money market fund or short-term bond fund. Any transfer to such an option must first go through an non-competing plan option and reside there for at least 90 days or three months.

and

2. For GICs that fund plan investment options where interest is allocated to plan participants based on how much of their account balance is in each particular interest rate “cell,” participants are not allowed to redirect any of the balance they have in a GIC funding a particular cell to a competing fund until the GIC’s maturity date.

In addition, the valuation actuary must be satisfied that the GIC provisions designed to reduce the C-3 risk are administered by the insurer in the designed manner.

This requirement may be fulfilled by obtaining from the appropriate insurance company officer a certificate of intent regarding the insurance company administration of the provisions.

In addition, the valuation actuary must periodically review the actual experience under the contract to verify the appropriateness of the Plan Type assumption with reference to this Guideline.
VALUATION ISSUES VS. POLICY FORM APPROVAL

Background

Occasionally, the NAIC Life and Health Actuarial Task Force addresses valuation (reserve) issues related to a policy form or benefit design that has not been accepted or approved by a particular state. The development of reserving methods or providing guidance concerning reserve questions for such policy forms is necessary because the annual statement filed in each state, including states for which a particular policy form has not been approved for use, must reflect appropriate reserve for all policy forms and associated benefits.

Text

The adoption of an Actuarial Guideline by the NAIC Life and Health Actuarial Task Force dealing with a reserve issue associated with a particular policy form or benefit does not represent an endorsement for the approval of the particular policy form or benefit.
RESERVE FOR IMMEDIATE PAYMENT OF CLAIMS

Background Material

Section 5 Reserve Valuation Method—Life Insurance and Endowment Benefits of the NAIC Standard Valuation Law refers to an annual premium in defining the commissioners reserve valuation method. However, it has been general practice to hold an additional reserve where fractional premiums are paid and any fractional premium not yet due in the policy year of death is waived and to hold a further additional reserve for the refund of any premium paid beyond the end of the month in the policy year of death. These additional reserves are called for in the Miscellaneous Section of Exhibit 8 of the annual statement. These additional reserves are generally included in the basic reserves where an insurer uses an assumption of continuous payment of premiums.

Although Section 7 of the NAIC Standard Nonforfeiture Law for Life Insurance explicitly permits in calculating nonforfeiture “the assumption that any death benefit is payable at the end of the policy year of death,” there is no similar explicit permission to use such assumption in the NAIC Standard Valuation Law. The annual statement instructions are silent on any adjustment. A long time ago some life insurance policies provided that claims would be paid at the end of the policy year of death. However, for many years many policies have provided that claims will be paid immediately upon satisfactory proof of death. In fact, some states require that interest shall accrue from date of death.

Many insurers have held a reserve for immediate payment of claims either by an adjustment to curtate reserves or by including provision therefore in the basic reserves calculated on a continuous payment of claims basis.

Text

RESERVES FOR IMMEDIATE PAYMENT OF CLAIMS

I. Reserves based on either fully continuous functions or on semi-continuous functions where the death portion reflects approximately one half of one year’s valuation rate of interest are considered as making appropriate provision for immediate payment of claims.

II. Where the basic reserves are based on curtate functions with no provision for immediate payment of claims:

1. For any policy where the contract calls for payment of death claims at the end of the policy year in which death occurs, no adjustment to curtate reserves need be made.

2. For any policy where the contract calls for payment of death claims immediately upon receipt of due proof of death of the insured, the death portion of curtate reserves shall be increased by one third of one year’s valuation rate of interest. (Approximations may be used to split the total curtate reserves into death portion and the pure endowment portion.)

3. For any policy where the contract provides for payment of interest on the death proceeds from date of death to date of payment, the death portion of curtate reserves shall be increased by one half of one year’s valuation rate of interest. (Approximations may be used to split the total curtate into the death portion.)

III. Where an insurer pays interest on death proceeds at an earlier point than as required by contract, it is appropriate that the statutory formula reflect such practice.
IV. Where the actual formula reserves are more conservative than minimum statutory formula reserves, an insurer using curtate functions without provision for immediate payment of claims must demonstrate compliance with minimum statutory formula reserves adjusted in accordance with II above.

V. This guideline shall apply to all new life insurance policies issued beginning January 1 following the date the guideline is adopted.

VI. The guideline shall be applicable to policies issued prior to the date the guideline is adopted with any additional reserve graded in as follows for the years following the date the guideline is adopted:

1. First year 20%
2. Second year 40%
3. Third year 60%
4. Fourth year 80%
5. Fifth and later years 100%
DETERMINING CARVM RESERVES
FOR ANNUITY CONTRACTS WITH ELECTIVE BENEFITS

Background Information

1. Introduction

The Standard Valuation Law (SVL) defines the methods and assumptions which are to be used in determining minimum statutory formula reserves. This law establishes the standards for annuity contracts (which therefore includes any annuity riders or endorsements, and any or all components of which, such as premiums, benefits, contract charges, primary or secondary accumulation values or other components, either relating to annuity benefits provided by the contract or providing separate annuity benefits) and includes the criteria for the interest and mortality assumptions to be used in determining minimum formula contract reserves. The 1980 revisions to the SVL provide for the maximum statutory formula reserve interest rate to be determined through a dynamic formula in order to incorporate changes in economic conditions, liquidity needs and the risks inherent in certain types of contracts.

The SVL defined methodology for annuity contracts, the commissioners annuity reserve valuation method (CARVM), requires that reserves be the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits, including guaranteed nonforfeiture benefits, provided for by such contracts at the end of each respective contract year, over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of such contracts, that become payable prior to the end of such respective contract year. Such reserves are established to adequately fund all guaranteed contract obligations, including those obligations which are optional to the contract owner and which may not have yet been elected.

Industry practices and methods of reserving under CARVM for annuity contracts with multiple benefit streams have not been found to be consistent. These range from a low reserve equal to the cash surrender value to a reserve representing the greatest actuarial present value of the future benefit streams under all potential annuity or other nonforfeiture benefit election options using a conservative rate of interest.

The major purpose of this Actuarial Guideline is to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams. Some of the areas requiring clarification include: the valuation of annuitization benefits; the application of incidence rates in CARVM; the application of the integrated benefit stream approach in CARVM; how to determine valuation interest rates and mortality tables for multiple benefit streams; and certain practical considerations regarding multiple benefit streams.

2. Annuitization Benefits

Varying forms of contracts provide that the cash value available to the contract owner is less than the amount available to purchase an annuitization option under the terms of the contract.

For purposes of this Actuarial Guideline, “accumulation fund” is defined as the policy value which is used to purchase an annuity option under the terms of the contract.

Frequently there are significant discontinuities in the reserves, both upward and downward, at the time a settlement option is elected, between the reserve held immediately prior to the settlement as
compared to the reserve required for the greatest actuarial present value of the annuitization option elected.

One of the most significant reasons for discontinuities in the reserve patterns at the time of election is the difference in the SPIA valuation rate available at the time of election as compared to the valuation rate used based on the date of issue of the original SPDA contract. Another significant reason is the difference between the guaranteed purchase rate contained in the contract and used for reserve development as compared to the rate actually used to purchase the annuity option at the time of election.

3. Application of Incidence Rates in CARVM

Since CARVM was adopted, there has been an increase in the types of benefits offered under certain annuity contracts, including enhanced death benefits, nursing home benefits, and various partial withdrawal provisions. For some of these benefit types, the SVL is not explicit as to whether incidence tables prescribed under the SVL may be used to determine such benefits, versus requiring consideration of all contract owner options available under the contract, and choosing the set of incidence rates which produce the greatest present value.

4. Integrated Benefit Stream Approach

CARVM requires that reserves be based on the greatest present value of all potential future guaranteed benefits. For annuity contracts offering more than one type of potential benefit stream, the SVL is not explicit regarding whether or how blends of more than one type of benefit must be considered under CARVM.

Under the integrated benefit stream approach, any potential benefit stream must be considered, including blends reflecting the interaction of more than one type of benefit. Such potential benefit streams include all types of benefits for which the greatest present value concept is required. Additionally, adjustments must be made to all such potential benefit streams to reflect those benefit types for which prescribed incidence tables are required (e.g., death benefits).

For example, consider an annuity contract offering surrender, annuitization and death benefits. Potential benefit streams that would be considered include surrender streams, annuitization streams, and streams reflecting blends of surrender and annuitization benefits. All such streams would also be adjusted to reflect death benefits and to discount all benefits for survivorship (based on the mortality table prescribed in the SVL).

5. Valuation Interest Rates

For annuities offering more than one type of benefit, the SVL is not explicit as to how valuation interest rates should be determined. The SVL is also not explicit as to how valuation interest rates should be determined for certain types of benefits offered under annuity contracts, such as death and nursing home benefits.

**Purpose**

The purpose of this Actuarial Guideline is to codify the basic interpretation of CARVM and does not constitute a change of method or basis from any previously used method, by clarifying the assumptions and methodologies which will comply with the intent of the SVL. This Actuarial Guideline shall apply to all annuity contracts subject to CARVM, where any elective benefits (as defined below) are available to the contract owner under the terms of the contract. However, life or health insurance riders attached to an annuity contract, where all components of the rider (e.g.,
premiums, benefits, contract charges, accumulation values and other components) are separate and distinct from the components of the annuity contract, should be treated as a separate life or health insurance contract not subject to this Actuarial Guideline. While this Actuarial Guideline applies to all annuity contracts subject to CARVM, in the event an actuarial guideline or regulation dealing with reserves is developed for a specific annuity product design, the product specific actuarial guideline or regulation will take precedence over the Actuarial Guideline.

**Definitions**

1. **Elective and Non-Elective Benefits in CARVM**

   For purposes of determining reserves under CARVM, each benefit available under the annuity contract must be placed into one of the two categories defined as follows:

   **Non-Elective Benefits**: Benefits that are payable to contract owners or beneficiaries only after the occurrence of a contingent or scheduled event independent of a contract owner’s election of an option specified in the contract, including (but not limited to) death benefits, accidental death benefits, disability benefits, nursing home benefits, and benefits payable under either a deferred or immediate annuity contract (with or without life contingencies), where no benefit options are available under the terms of the contract.

   **Elective Benefits**: Benefits that do not fall under the non-elective benefits category (i.e., benefit options that may be freely elected under the terms of the contract). Elective benefits include (but are not limited to) full surrenders, partial withdrawals, and full and partial annuitizations.

   In some cases it may not be clear whether some benefits are elective or non-elective. For example, some annuity contracts offer benefits which vary depending upon the age of retirement. In such cases, the Valuation Actuary should use judgment in making this determination, by considering factors such as the degree to which contract owner actions would be influenced by the availability of the benefit.

2. **Elective and Non-Elective Incidence Rates in CARVM**

   For non-elective benefits, incidence rates from tables prescribed by the SVL should be applied to determine the payment of non-elective benefits and to discount, for survivorship, all benefit payments included in an Integrated Benefit Stream, as defined below. If no incidence tables are prescribed by the SVL, then company or industry experience (with margins for conservatism) may be used, as appropriate. Annuity mortality tables prescribed by the SVL should be used to determine all mortality based benefits under the contract (including, but not limited to, annuitizations and death benefits) and to discount other types of benefit payments for survivorship.

   For elective benefits, incidence rates should not be based on tables reflecting past company experience, industry experience or other expectations. Instead, every potential guaranteed elective benefit stream required to be reserved by CARVM must be considered in the determination of integrated benefit streams as defined below. This is accomplished by considering trial sets of guaranteed elective benefit incidence rates, either through numerical testing or analytical means, to determine which trial set produces the “greatest present value” as described in Text paragraph 1 below. Theoretically, this means that all possible elective benefit incidence rates between 0% and 100% should be considered. However, in practice, such a greatest present value will typically occur by assuming an incidence rate of either 0% or 100%.
3. Integrated Benefit Stream

An integrated benefit stream is one potential blend of guaranteed elective and non-elective benefits available under the contract, determined as the combination of A and B, where:

A equals one potential stream of one or more types of guaranteed elective benefits available under the terms of the contract, based upon a chosen set of elective benefit incidence rates; and

B equals the stream of all guaranteed non-elective benefits provided under the terms of the contract, recognizing the guaranteed elective benefit stream under consideration in A above, and the non-elective incidence rates defined in 2. above.

Both A and B above should be discounted for survivorship, based on the non-elective incidence rates defined in 2. above.

Text

1. Greatest Present Value

All guaranteed benefits potentially available under the terms of the contract must be considered in the valuation process and analysis and the ultimate policy reserve held must be sufficient to fund the greatest present value of all potential integrated benefit streams, reflecting all guaranteed elective and non-elective benefits available to the contract owner. Each integrated benefit stream available under the contract must be individually valued and the ultimate reserve established must be the greatest of the present values of these values, based on valuation interest rate(s) as defined in Section 3 below.

2. Examples of Integrated Benefit Streams That Must Be Considered

A. Cash Value Streams

One mandatory set of integrated benefit streams for a deferred annuity with cash settlement values which must always be considered is any possible blend of future guaranteed partial withdrawals and full surrenders available under the contract, as specified in the SVL, accumulated at the guaranteed credited interest rate(s) and discounted at the valuation rate(s) of interest defined in section 3 below, with appropriate recognition of all guaranteed non-elective benefits available under the contract.

B. Annuitization Streams

A second mandatory set of integrated benefit streams that must be considered is any possible blend of future guaranteed full or partial annuitization elections, as specified in the SVL, available to the contract owner at each election date required by CARVM, with appropriate recognition of all guaranteed non-elective benefits available under the terms of the contract. In determining the integrated benefit streams to value the annuitization option, the guaranteed purchase rates contained in the contract, as well as any other contract provisions, excluding any current purchase rates which may be applicable, are applied to the accumulation fund.

C. Other Elective Benefit Streams

In addition to the cash value and annuitization streams described above, all other possible guaranteed elective benefits available under the contract, including blends of more than one type of guaranteed elective benefit, must be considered in a manner consistent with the mandatory
cash value and annuitization streams, with appropriate recognition of all guaranteed non-elective benefits available under the contract.

3. Determination of Valuation Interest Rates

Section 4b of the SVL determines valuation rates for an annuity contract based on the following Parameters:

A. The basis of valuation (issue year or change in fund);
B. Whether or not the annuity provides for cash settlement options;
C. Whether interest is guaranteed on premiums received more than 12 months following issue (or the valuation date for change in fund basis);
D. The guarantee duration; and
E. The Plan Type.

Parameters A, B and C above should be determined at a contract level. Additional requirements regarding the change in fund basis of valuation are set forth in Section 5 below. Parameters D and E should be determined at a benefit level, as set forth in Section 4 below.

Under a contract level determination, parameters are set based on the characteristics of the contract as a whole. Under a benefit level determination, parameters are set based on the characteristics of each benefit, resulting in potentially different valuation rates for each benefit type comprising the integrated benefit stream.

4. Determination of Guarantee Duration and Plan Type

Guarantee duration and Plan Type are based upon the specific characteristics of each individual benefit type that comprise the integrated benefit stream, as follows:

A. For portions of the integrated benefit stream attributable to full surrender and partial withdrawal benefits, the Plan Type should be based upon the withdrawal characteristics of the benefit, as stated in the contract. This may result in a Plan Type A, B or C under the 1980 amendments of the SVL. The guarantee duration is the number of years for which interest rates are guaranteed in excess of the calendar year statutory valuation interest rate for life insurance policies with guarantee duration in excess of twenty (20) years.

B. For portions of the integrated benefit stream attributable to full and partial annuitization benefits, the determination of the valuation interest rate involves the use of the appropriate Plan Type and weighting factor as determined by the SVL, with the guarantee duration as the number of years from the original date of issue or date of purchase, to the date the annuitization is assumed to commence. If the underlying assumption is that the contract owner may withdraw funds only as an immediate life annuity or as installments over 5 years or more, this will generally result in a Plan Type A, under the 1980 amendments of the SVL, with the valuation interest rate changing as different assumed annuitization dates determine guarantee durations which will fall into different guarantee duration bands under the SVL. An assumed annuitization option which has a non-life contingent payout period of less than five (5) years shall be considered a Plan Type C, with the valuation interest rate changing as different assumed annuitization dates determine guarantee durations which will fall into different guarantee duration bands under the SVL.

C. For portions of the integrated benefit stream attributable to non-elective benefits, since the underlying assumption is that no withdrawal is permitted, Plan Type A should generally be used, with a guarantee duration determined as the number of years from issue or purchase to the date non-elective benefits may first be paid. In most cases, the guarantee duration should be less than
five years, since non-elective benefit coverage usually begins immediately after issue, with benefits payable commencing in the first contract year.

For benefit types incorporating multiple payments, paragraphs 4(A), 4(B), and 4(C) above should be applied to each separate payment according to the withdrawal, annuitization, or non-elective benefit characteristics of the contract and payment provisions at the time each payment is to be made. If a portion of the integrated benefit stream is part of an immediate life annuity or a series of installments over five (5) years or more, but can be changed directly or indirectly by exercise of contract owner withdrawal options, then it would be inappropriate to apply paragraph 4(B) to that portion of the integrated benefit stream, since the contractholder may withdraw funds other than as a life annuity or in installments of five (5) years or more.

For example, a Guaranteed Lifetime Income Benefit (GLIB) is a guarantee to the owner of a fixed deferred annuity contract, whether traditional or indexed to an external referent such as an equity index, that the owner can have a defined income for life in an amount determined by formula, while the owner retains traditional rights (such as withdrawal) to the other values provided by the underlying deferred annuity and while such values continue to exist. Income benefits are typically deducted from one or more of the annuity’s defined values to the extent such values remain positive. Once the GLIB is elected, the contract owner may have rights to stop and restart the income benefit and may also request full or partial surrender of any remaining annuity value, though doing so may negatively impact or eliminate subsequent guaranteed income benefits. Thus, applying 4(A) and 4(B) above, the GLIB benefit stream is seen to be composed of two portions to determine the Plan Type and guarantee duration, as follows:

The first portion consists of the series of defined payments to the extent that the payments, or any fraction thereof, are withdrawals that reduce or deplete the annuity’s defined values. Applying paragraph 4(A) to this portion would result in Plan Type A, Plan Type B, or Plan Type C, by following the definitions of such contained within the Standard Valuation Law and reflecting the specific contract provisions, especially with regard to withdrawal. Paragraph 4(A) would also apply to any residual withdrawals that can be made following election of the GLIB benefit.

The second portion is a life annuity without option to take or receive additional amounts under the contract, and consists of the payments not included in the above portion. Applying paragraph 4(B), Plan Type A would generally apply to this segment with the guarantee duration determined using the period from contract issue to commencement of payments in this second portion.

5. Change in Fund Basis

As indicated by section 4b.C.(1)(c)(vi) of the SVL, a company may elect to value annuity contracts with cash settlement options on either an issue year basis or on a change in fund basis. Annuity contracts with no cash settlement options must be valued on an issue year basis. The issue year basis or change in fund basis should be determined for the contract as a whole, and thus must be consistently applied to all portions of all integrated benefit streams available under the annuity contract. The election of issue year or change in fund basis must be made at the issuance of the contract and must not change during the term of the contract without the prior written approval of the commissioner.

6. Purchase Rates

Contracts may provide, as contractual guarantees, the use of preferential purchase rates to those listed in the contract. As an example, a contract may provide that the company will offer, at the time of
annuitization, the rates offered to new purchasers of immediate annuities if such rates will provide a higher annuity benefit than would result from the contractually guaranteed rates provided in the contract. This creates a contract guarantee which must be valued under CARVM. Ignoring this benefit in determining reserves will produce reserves less than the statutory formula reserves required under CARVM. Valuation of this benefit, however, is complicated by the fact that the company does not currently know what the exact rate will be at the time of the settlement election. In order to determine conservative statutory formula reserves, if use of future unknown rates are guaranteed, the company shall establish reserves not less than the contract’s accumulation fund value, on the valuation date, reduced by an “expense allowance” not to exceed 7% of such fund. This section does not require the calculation of a reserve for the annuitization of business based upon current purchase rates pursuant to the “annuitization streams” described in Paragraph 2.B. above.

Likewise for contracts which provide for additional amounts during the payout period over those guaranteed at the commencement of the annuity payments, the reserve during the deferred period shall not be less than the contract’s accumulation fund reduced by an expense allowance not to exceed 7% of such fund.

7. Practical Considerations

The major purpose of this Actuarial Guideline is to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams. However, in practice there may be other acceptable methods of applying CARVM which are substantially consistent with the methods described in this Actuarial Guideline. Such methods may also be used, with prior regulatory approval.

Additionally, in applying this Actuarial Guideline there may theoretically be an infinite number of contract owner options that are possible under the contract. However, it may not be practical, possible or even appropriate to test every conceivable combination of potential integrated benefit streams theoretically available under the contract. This Actuarial Guideline requires that the actuary consider, not necessarily test, all potential integrated benefit streams to determine to what extent each contract owner option has a material impact on the reserve. In practice, the actuary may be able to eliminate some potential integrated benefit streams by analytical methods. The actuary may also be able to demonstrate the reserve adequacy of certain approximations. For example, in certain situations it may be shown that a CARVM reserve ignoring non-elective benefits, plus an “add-on” reserve for non-elective benefits, is a reasonable approximation for the theoretically correct CARVM reserve.

Effective Date

This guideline shall be effective on December 31, 1998, affecting all contracts issued on or after January 1, 1981. A company may request a grade-in period for contracts issued prior to December 31, 1998 from the domiciliary commissioner upon satisfactory demonstration that the method and level of current reserves held for such contracts are adequate in the aggregate. This phase-in will require establishment of no less than 33 1/3% of the additional reserves resulting from the application of this guideline on December 31, 1998, no less than 66 2/3% on December 31, 1999, and 100% by December 31, 2000.
I. Background

The purpose of this Actuarial Guideline is to interpret the standards for the valuation of reserves for Minimum Guaranteed Death Benefits (MGDBs) included in variable annuity contracts. This Guideline codifies the basic interpretation of the Commissioners Annuity Reserve Valuation Method (CARVM) by clarifying the assumptions and methodologies which will comply with the intent of the Standard Valuation Law (SVL).

For many years the industry has struggled with the issue of applying a uniform reserve standard to variable annuities in general, and to MGDBs in particular. Three regulatory sources are often looked to for guidance. First, the SVL requires that CARVM be based on the greatest present value of future guaranteed benefits. Second, Actuarial Guideline XXXIII requires that “each benefit stream available under the contract must be individually valued and the ultimate reserve established must be the greatest of the present values of these values.” Third, the NAIC model Variable Annuity Regulation (VAR) states that the “reserve liability for variable annuities shall be established pursuant to the requirements of the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.”

This Guideline interprets the standards for applying CARVM to MGDBs in variable annuity contracts, employing methods that recognize the variable nature of the benefits. It clarifies standards for developing integrated benefit streams, where MGDBs are integrated with other benefits such as surrenders and annuitizations. It also clarifies standards for determining the level of reserve to be held in the General Account.

This Guideline requires that MGDBs be projected by assuming an immediate drop in the values of the assets supporting the variable annuity contract, followed by a subsequent recovery at a net assumed return until the maturity of the contract. The projection should reflect the contractual definition of the MGDB and any contractual limitations, such as provisions that terminate the MGDB at a given age and those that restrict the MGDB to a given multiple of contract contributions. The immediate drops and assumed returns used in the projection vary by five asset classes in order to reflect the risk/return differentials inherent in each class.

This Guideline also interprets the mortality standards to be applied to projected MGDBs in the reserve calculation. As part of the study of mortality experience under variable annuities during the deferral period, the Society of Actuaries’ Task Force on Mortality Guarantees in Variable Products will be validating the appropriateness of this mortality standard and, if necessary, recommend an alternative course of action.

In addition, this Guideline clarifies standards for reserve methods for reinsurance transactions involving MGDBs. Unlike the annuity writer, the reinsurer may not be able to integrate the MGDB with other base contract benefits, since the reinsurer does not normally reinsure any aspects of the variable annuity other than the death benefit. The reinsurer and the direct writer do face identical fund performance risks, so it is appropriate that the reinsurer’s reserve method incorporate the same immediate drops and recoveries as the direct writer. Similarly, the reinsurer’s reserve method should include a future projection of MGDB levels, to appropriately assess future death benefit obligations. Furthermore, just as the direct writer’s
reserve calculation should recognize the underlying asset charges, the reinsurer’s reserve calculation should recognize reinsurance premiums.

Finally, there are some companies that have not applied CARVM in calculating variable annuity reserves. For example, some companies have held a reserve equal to the account value. Such companies may be able to demonstrate that their reserves meet or exceed the levels set by applying this Guideline, and that no additional MGDB reserves are required. Alternatively, other companies which have held a reserve equal to the cash surrender value may need to hold an additional MGDB reserve such that their total reserve is at least equal to the levels set by applying this Guideline. In these situations, the company must determine an appropriate allocation of the total reported reserve between the General and Separate Accounts.

II. Scope

This Guideline applies to variable annuity contracts which provide a Minimum Guaranteed Death Benefit that has the potential to exceed the account value, whether or not the MGDB exceeds the account value on the valuation date. This Guideline does not apply to group variable annuity contracts which are not subject to CARVM. Currently offered MGDBs falling under the scope of this guideline include, but are not limited to, provisions commonly referred to as Return of Premium, Roll-ups, Ratchets and Resets. However, the actuary should also exercise judgment in determining the applicability of this Guideline. For example, it may be inappropriate to utilize this Guideline for a contract with an MGDB where the associated net amount at risk (NAR) decreases when the underlying funds experience a drop in market value or a period of underperformance.

III. Definitions

“Reduced Account Value”: The account value on the valuation date, reduced by the sum of the immediate drops for each asset class, as defined in Section IV.D.

“Projected Reduced Account Value”: The Reduced Account Value, projected into the future using the Net Assumed Returns for each asset class, as defined in Section IV.D. The determination of the Projected Reduced Account Value need not reflect future partial withdrawals.

“Projected Net Amount at Risk”: The projected death benefit resulting from the MGDB and the Projected Reduced Account Value, less the Projected Reduced Account Value.

“Projected Unreduced Account Value”: The projected account value, without reduction for an immediate drop, projected using a return based on the valuation rate less appropriate asset based charges.

“Base Benefit Streams”: The streams of projected benefits reflecting the Projected Unreduced Account Values and ignoring MGDBs.

“Integrated Benefit Stream”: Streams which reflect the Base Benefit Streams discounted for survivorship and the MGDBs discounted for mortality.

“Calculation Period”: The periods for which the Integrated Benefit Streams are projected in the Integrated Reserve calculation, consisting of successive periods, beginning with the remainder of the contract year following the valuation date and ending with the period from the valuation date to the maturity date of the contract.
IV. Text

A. General Methodology

The valuation of reserves for MGDBs involves two CARVM reserve calculations: a Separate Account Reserve and an Integrated Reserve. The Integrated Reserve represents the total reserve held by the company in support of the entire variable annuity contract. The additional reserve held for the MGDB, which equals the excess of the Integrated Reserve over the Separate Account Reserve, but not less than zero, is held in the General Account.

B. Separate Account Reserve Calculation

The Separate Account Reserve represents the reserve that would be held in the absence of the MGDB.

C. Integrated Reserve Calculation

The Integrated Reserve is a CARVM reserve determined using all contract benefits, including the MGDB. It equals the greatest present value, as specified in the SVL and the VAR, of future Integrated Benefit Streams available under the terms of the contract.

The integration of the MGDB with other contract benefits in the determination of future Integrated Benefit Streams is accomplished by combining three separate benefit streams A, B and C described below. These future Integrated Benefit Streams are determined over all Calculation Periods, and are discounted at the valuation interest rate (discussed further in Section IV.E.).

- A is the stream of Projected Net Amounts at Risk paid to those expected to die during the Calculation Period, based on valuation mortality (discussed further in Section IV.E.).

- B is the benefit stream of Projected Unreduced Account Values paid to those expected to die during the Calculation Period, based on valuation mortality.

- C is the Base Benefit Streams provided during the Calculation Period, and is discounted for survivorship based on valuation mortality.

The greatest present value occurs in the Calculation Period in which the present value of the future Integrated Benefit Streams is maximized (as opposed to the present values of A, B and C being individually maximized).

The Integrated Reserve is also subject to the asset adequacy analysis requirement in subsection G.

D. Immediate Drops and Assumed Returns

The Projected Net Amount at Risk described in Section IV.C. is determined by assuming an immediate drop in the supporting asset values, followed by a subsequent recovery based upon a net assumed return.

For example, the Reduced Account Value after the immediate drop would equal the account value on the valuation date, multiplied by \((1 - \text{Immediate Drop Percentage})\). The Projected Reduced Account Value “\(n\)” years later would equal the Reduced Account Value multiplied by \((1 + \text{Net Assumed Return})^n\). The projection should continue until the maturity of the contract.

To determine the immediate drop and net assumed return, the Separate Account funds supporting the variable annuity contracts on the valuation date should be allocated to the five asset classes as follows:
• Equity Class
• Bond Class
• Balanced Class
• Money Market Class
• Specialty Class

Descriptions of these classes are contained in Appendix III. Since these descriptions are broad in nature, the ultimate determination of the appropriate fund classifications, for purposes of this Guideline, is the responsibility of the appointed actuary.

The Immediate Drop Percentages and Gross Assumed Returns for each asset class are shown in Appendix I. The Gross Assumed Returns shown do not include deductions for asset based charges. Each company should deduct its own asset based charges from those shown to obtain the Net Assumed Returns to be used in determining the Projected Reduced Account Values.

Many variable annuity contracts provide for various types of Fixed Account options, in which underlying guarantees, consistent with General Account annuities, are provided. The fixed account should be projected as a separate asset class, with an Immediate Drop Percentage equal to zero and a Net Assumed Return equal to the guaranteed rate(s).

The Immediate Drop for each contract is determined by taking the sum of the immediate drops for each asset class. The Net Assumed Return for each contract is determined by taking the weighted average of the Net Assumed Returns for each asset class, based upon the allocation of the total account value between the asset classes.

E. Valuation Mortality and Interest

The mortality basis used to discount projected death benefits is the 1994 Group Annuity Mortality Basic Table (1994 GAMB), increased by 10% for margins and contingencies, without projection. This table, referred to as the 1994 Variable Annuity MGDB Mortality Table, is shown in Appendix II.

The valuation interest rates used for both the Separate Account Reserve and the Integrated Reserve should be annuity valuation interest rates, consistent with those required in the SVL and the VAR.

F. Reinsurance Reserve

1. Reinsurance Ceded

For contracts which reinsure some or all of the MGDB, an Integrated Reserve net of reinsurance must be calculated. This reserve should be calculated as outlined in Section IV.C., with the Integrated Benefit Streams being modified to reflect both the payment of future reinsurance premiums and the recovery of future reinsured death benefits. This is accomplished by treating the future reinsurance premium as an additional benefit and reducing the MGDB in the benefit stream of the Integrated Reserve calculation by future reinsurance recoveries.

Similar to the formula demonstrated in Section IV.C., the determination of future Integrated Benefit Streams including the impact of reinsurance is accomplished by combining four separate benefit streams: A', B', C and D, described below. These future Integrated Benefit Streams are determined over all Calculation Periods, and are discounted at the valuation interest rate.
• **A** is the stream of Projected Net Amounts at Risk paid to those expected to die during the Calculation Period, based on valuation mortality. It is equal to benefit stream A defined in Section IV.C., reduced by future Projected Net Amounts at Risk reinsurance recoveries.

• **B** is the benefit stream of Projected Unreduced Account Values paid to those expected to die during the Calculation Period, based on valuation mortality. It is equal to benefit stream B defined in Section IV.C., reduced by future Projected Unreduced Account Values reinsurance recoveries.

• **C** is as defined in Section IV.C.

• **D** is the stream of future projected reinsurance gross premiums during the Calculation Period, determined using Projected Reduced Account Values and discounted for survivorship, using valuation mortality.

The greatest present value occurs in the Calculation Period in which the present value of the future Integrated Benefit Streams, net of reinsurance, is maximized. This Calculation Period does not necessarily have to be the same as the Calculation Period which maximizes the Integrated Benefit Streams before consideration of reinsurance.

The reinsurance reserve credit the ceding company is entitled to is equal to the difference between the Integrated Reserve before any consideration of reinsurance and the Integrated Reserve net of reinsurance. The Integrated Reserve net of reinsurance may be greater than the Integrated Reserve before any consideration of reinsurance (i.e., the reserve credit may be negative).

2. **Reinsurance Assumed**

The reserve for reinsurers assuming MGDB risk is the maximum difference, at each Calculation Period, between the present value of the reinsured death benefits and the present value of reinsurance premiums.

Referring to the formulas above, the reinsured death benefit is the difference between the combination of benefit streams A and B, while benefit stream D represents the stream of reinsurance premiums defined above (i.e., A-A'+B-B'-D). Each of these benefit streams is discounted using valuation mortality and interest assumptions consistent with those used by the ceding company.

The greatest present value occurs in the Calculation Period in which the difference between the present value of the reinsured death benefits and the present value of reinsurance premiums is maximized. This Calculation Period does not necessarily have to be the same as the Calculation Period which maximizes the Integrated Reserve, either before or after consideration of reinsurance.

G. **Asset Adequacy Analysis Requirement**

The Projected Reduced Account Value, and consequently, the Projected Net Amount at Risk need not reflect future partial withdrawals. There is also the possibility that other risks may not be reflected in the reserve calculations described above. Therefore, the appointed actuary shall perform a standalone asset adequacy analysis of the total reserve held for all of the contracts falling within the scope of this Guideline. Such analysis shall be performed reflecting the assets supporting the total reserve held for the contracts and all benefits and guarantees associated with the variable annuity contracts, as well as all expenses and charges associated with the variable annuity contracts. The analysis shall be performed on an aggregate basis, consistent with the requirements of Section 6 of the NAIC Model Actuarial Opinion...
and Memorandum Regulation, including the requirement that the analysis conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board. However, no separate actuarial opinion is required by this Guideline. If such analysis reveals a reserve shortfall, the total reserves held for the contracts must be increased accordingly.

Where Minimum Guaranteed Death Benefits are reinsured, the asset adequacy analysis may reflect the reinsurance. However, if the inclusion of reinsurance would increase the Integrated Reserve, then reinsurance must be reflected in the asset adequacy analysis.

**H. Effective Date**

This Guideline affects all contracts issued on or after January 1, 1981. Where the application of this Guideline produces higher reserves than the company had otherwise established by their previously used interpretation, such company must comply with this Guideline effective December 31, 1998. However, such company may request a grade in period, of not to exceed three (3) years, from the domiciliary Commissioner upon satisfactory demonstration of the previous interpretation and that such delay of implementation will not cause a hazardous financial condition or potential harm to its policyholders.
APPENDIX I

Immediate Drop Percentages and Gross Assumed Returns

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<th>IMMEDIATE DROP PERCENTAGE</th>
<th>GROSS ASSUMED RETURN</th>
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APPENDIX II

1994 Variable Annuity MGDB Mortality Table
FEMALE Age Last Birthday

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## APPENDIX II

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### APPENDIX II

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### 1994 Variable Annuity MGDB Mortality Table

**MALE Age Nearest Birthday**

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| 13  | 0.302   | 36  | 1.020   | 59  | 8.385   | 82  | 89.339  | 105 | 484.644  |
| 14  | 0.352   | 37  | 1.054   | 60  | 9.434   | 83  | 97.593  | 106 | 506.047  |
| 15  | 0.408   | 38  | 1.111   | 61  | 10.629  | 84  | 105.994 | 107 | 522.720  |

| 16  | 0.463   | 39  | 1.182   | 62  | 12.002  | 85  | 115.015 | 108 | 534.237 |
| 17  | 0.509   | 40  | 1.268   | 63  | 13.569  | 86  | 125.131 | 109 | 542.088 |
| 18  | 0.544   | 41  | 1.367   | 64  | 15.305  | 87  | 136.815 | 110 | 546.908 |
| 19  | 0.573   | 42  | 1.481   | 65  | 17.192  | 88  | 150.191 | 111 | 549.333 |
| 20  | 0.599   | 43  | 1.599   | 66  | 19.208  | 89  | 164.944 | 112 | 550.000 |

| 21  | 0.627   | 44  | 1.725   | 67  | 21.330  | 90  | 180.886 | 113 | 550.000 |
| 22  | 0.658   | 45  | 1.867   | 68  | 23.489  | 91  | 197.834 | 114 | 550.000 |
| 23  | 0.696   | 46  | 2.037   | 69  | 25.700  | 92  | 215.601 | 115 | 1000.000 |
APPENDIX III

Description of Asset Classes

Equity Class

Although equity funds have a broad range of investment objectives, all invest primarily in publicly traded securities, such as common stocks, preferred stocks and convertible securities. The choice of securities purchased by the portfolio manager will be guided by the fund objective (such as Growth of Capital or Income, or Approximating an Index), the capitalization of the companies issuing the stock (e.g., small, medium or large) or the target region (domestic U.S., Pacific Rim, Latin America, etc.). Although some equity funds maintain a general strategy, allowing a portfolio manager great latitude in purchase, other equity funds have become quite specific in their investment objectives. All equity funds, however, are somewhere on the high end of the risk/return scale.

Bond Class

Investment objective is usually to provide a high level of income consistent with moderate fluctuations in principal value. The objective is accomplished through investments in fixed income securities, such as U.S. government securities, foreign government securities, or publicly traded debt securities issued by U.S. or foreign corporations. Since most bonds are assigned ratings by private Rating Agencies, the specific objectives of the funds are often described by the funds’ tolerance for instruments at the various rating levels. Funds that focus predominantly on safety will tend to use more U.S. Government securities, while a fund that focuses predominantly on income may tend to use more lower investment grade instruments. All bond funds, however, are somewhere in the midrange of the risk/return scale.

Balanced Class

Investment objective is to seek a maximum total return over time, consistent with an emphasis on both capital appreciation and income. Typically, these funds will contain 50%-75% stocks, with the remaining assets invested in bonds and cash equivalents. However, balanced funds grant the portfolio manager the latitude to shift the asset allocation depending on a current analysis of market trends. Beside the term “Balanced,” common terms for this fund type include “Total Return,” “Adviser’s” and “Asset Allocation.”

Money Market Class

Investment objective is to achieve maximum current income consistent with liquidity and preservation of capital. These funds typically aim to maintain a stable net asset value of $1 per share. The assets contained in this fund typically have a stated maturity of less than thirteen months with an average maturity of less than 90 days. Common assets held include U.S. Government obligations, certificates of deposit, time deposits and commercial paper.

Specialty Class

Investment objective is to seek a maximum total return with an emphasis on long term capital appreciation, and sometimes current income. Typically, this fund type will invest most of its assets in common stocks or debt instruments of companies that operate within a specified industry. Commonly, specialty funds invest in utilities, natural resources and real estate, although there is a broad range of possible industries to choose from. The key difference between a specialty fund and an equity or bond fund is the targeted approach to investing. In a specialty fund, no effort is made to diversify outside the target industry.
Background

The purpose of this Actuarial Guideline is to interpret the standards for the valuation of reserves for equity indexed annuities. This Guideline codifies the interpretation of the Commissioners Annuity Reserve Valuation Method (CARVM) by clarifying the computational methodologies which will comply with the intent of the Standard Valuation Law (SVL).

Equity indexed deferred annuity products provide policyholders with a minimum guaranteed interest accumulation rate on a portion of all premium payments and a portion of the growth, if any, of an equity based index such as the S&P 500. While there is no “typical” equity indexed product, there are design features that are common to most products. Some of these features are a participation rate guaranteed for one or more years, a cap on the portion of the index growth that is credited to policyholders, and a policy term which defines a time period for which current guarantees are applicable.

Equity indexed immediate annuity products provide policyholders with a minimum guaranteed annuitization rate and an opportunity to receive larger periodic payments based on the growth, if any, in an equity index. The product design may include features such as a participation rate, cap or term.

While contract parameters such as participation rate and cap are guaranteed for a period of time, growth of the underlying index is not. Index growth may be positive or negative. This combination of guaranteed parameters and unknown equity index growth makes the application of CARVM to these products problematic.

CARVM defines minimum statutory reserves as “the greatest of the respective excesses of the present value, at the date of valuation, of the future guaranteed benefits, including guaranteed nonforfeiture benefits, … over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of such contract, that become payable prior to the end of such respective contract year. The future guaranteed benefits shall be determined by using the mortality table, if any, and the interest rate, or rates, specified in such contracts for determining guaranteed benefits.”

In order that all insurers issuing equity indexed annuity products establish reserves for statutory reporting purposes that are consistent with CARVM minimum statutory formula reserves requirements, this actuarial guideline identifies a computational method that is deemed to be consistent with CARVM in situations when specific operational criteria called “Hedged as Required” criteria are met. In addition, two computational methods are defined that are deemed to be consistent with CARVM in the event the “Hedged as Required” criteria are not met.

Two forms of the “Hedged as Required” criteria are provided. The “basic” criteria are applicable when an insurer uses long dated options to hedge the equity risk embedded in an equity indexed annuity. The second set of criteria is applicable when an insurer uses an option replication strategy.

Scope

This Actuarial Guideline applies to all equity indexed annuity contracts, regardless of the date of issue, that are subject to CARVM.
Computational Methods

Computational methods deemed to be consistent with CARVM can be classified into two groups, Type 1 methods and Type 2 methods. The following computational method is considered a Type 1 method: the Enhanced Discounted Intrinsic Method (EDIM). Type 1 computational methods are deemed to be consistent with CARVM if the applicable “Hedged as Required” are met. The following methods are considered Type 2 methods: the Commissioners Annuity Reserve Method with Updated Market Values (CARVM with UMV) and the Market Value Reserve Method (MVRM). Also, an adaptation of the MVRM, known as the Black-Scholes Projection Method (BSPM), is recognized. For a complete description of these methods, please consult Attachment 1.

General Requirements on the Use of Certain Computational Methods

The MVRM and EDIM computational methods are both based on a future value. In the case of MVRM, a projected index is determined. The projected index is then used to determine end of term and interim benefit amounts. CARVM is applied to these benefit amounts. In the case of EDIM, the end of term guaranteed value (a future value) is used to determine an interest rate for calculating terminal reserves for the guaranteed benefits after the initial terminal reserve. Determination of the “term” is an essential component of both computational methods.

The EDIM, MVRM and the BSPM adaptation of the MVRM computational methods are considered acceptable interpretations of CARVM under the following conditions:

1. The policy form design features a single dominant benefit which is the most likely benefit to be provided under the policy form with the determination of the single dominant benefit based on a consideration of product features such as the pattern of guaranteed participation rates, surrender charges, vesting rates, spread deductions, and marketing/advertising material.

2. The point in time associated with the single dominant benefit most likely to be provided under the contract is used as the terminal point of the current term for purposes of applying the computational method and complying with the “Hedged as Required” criteria, if applicable.

3. The appointed actuary has demonstrated to the satisfaction of the regulatory officials in each state in which the insurer is required to submit a statutory financial statement, prior to the use of the MVRM or EDIM computational methods, that the requirements above have been met.

Variations from the MVRM and EDIM as described in Attachment 1, are not acceptable interpretations of CARVM. The BSPM is considered an acceptable adaptation of the MVRM.

Type 1 Methods

A Type 1 computational method is deemed to be consistent with CARVM if an insurer using the method complies with the applicable “Hedged as Required” criteria (Attachment 2) and provides a certification as to compliance with the criteria. The certification must be signed by the appointed actuary. The certification shall be provided with each annual and quarterly statutory financial statement filed with the appropriate insurance regulatory official in each state in which the insurer does business.

For purposes of determining compliance with the “equivalence of characteristics” requirement in the “Hedged as Required” criteria, the current term of an equity indexed deferred annuity policy will be determined based on the requirements in the section captioned “General Requirements on Use of Certain Computational Methods.” For purposes of applying a Type 1 computational method, the time horizon for...
present value calculations should be based on the current term of the policy based on the requirements in the section captioned “General Requirements on Use of Certain Computational Methods.”

The Enhanced Discounted Intrinsic Method (EDIM) requires an initial reserve amount that is determined by methods that are not specifically included in the EDIM. For purposes of compliance with statutory minimum formula reserve requirements, the initial reserve under EDIM must be set at least equal to the initial reserve produced by either CARVM with UMV, or the MVRM with assumptions used to compute any necessary option market values reasonable as of the date of issue of the policy. The insurer must provide a certification (Attachment 3) as to the reasonableness of the assumptions.

**Type 2 Methods**

The use of Type 2 method is not conditioned upon the requirement to meet the “Hedged as Required” criteria. However, an insurer using a Type 2 method must provide a certification (Attachment 4) signed by the appointed actuary with each annual and quarterly statutory financial statement filed with the appropriate insurance regulatory official in each state in which the insurer does business. This certification deals with the assumptions underlying the option market values included in the calculation of reserves using a Type 2 method and the consistency in assumptions between these option market values and the statement value of any options owned by the insurer to support the equity indexed annuity business being valued.

For purposes of applying the MVRM and the BSPM recognized adaptation computational methods, the time horizon for present value calculations should be based on the requirements in the section captioned “General Requirements on Use of Certain Computational Methods.”

**Required Change in Method**

In the event an insurer that is using a Type 1 computational method for a block of business fails to meet the applicable “Hedged as Required” criteria, the required actuarial certification must disclose this fact. If the reason for failing the “Hedged as Required” criteria is not corrected within one quarterly financial reporting of the initial disclosure of the failure in the actuarial certification, the insurer must use a Type 2 computational method for determining minimum statutory formula reserves for this block of business.

If at a later date, the insurer can demonstrate to the satisfaction of its domiciliary commissioner that it is meeting the applicable “Hedged as Required” criteria, the insurer may, with the approval of the domiciliary commissioner, resume using a Type 1 computational method. In addition, the insurer must notify the appropriate regulatory official in each state in which the insurer does business subject to the change in computational method.

**Optional Change in Method**

An insurer using either a Type 1 or Type 2 computational method for a block of business, may with the approval of its domiciliary commissioner and after notifying the appropriate regulatory official in all the other states in which the insurer writes this block of business, use a computational method of the other type. If the change in computational methods involves a change from a Type 2 computational method to a Type 1 computational method, the request to the domiciliary commissioner for approval of the change in method must be accompanied with a demonstration of compliance with the applicable “Hedged as Required” criteria.
Plan Type

The use of either a Type 1 computational method or a Type 2 computational method requires a determination of Plan Type for purposes of determining the maximum valuation interest rate. Design features unique to equity indexed annuities, such as an equity enhanced surrender values, vesting schedules, or participation rate, should not be used to determine the Plan Type of a policy form. Only those design features specifically identified in Section 4b. Paragraph C of the NAIC Model SVL may be used to assign a Plan Type to a policy form.

The definition of Plan Type A and Plan Type B in the NAIC Model SVL includes the phrase “with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company...” The reference to “change in ... asset values” does not include changes in policy values due to changes in the equity index underlying the policy form.

Other Regulatory Requirements

The guidance provided in this Actuarial Guideline concerning statutory minimum formula reserves for equity indexed annuity products supersedes the valuation guidance in Sections 5 and 6 of the NAIC Interest-Indexed Annuity Contracts Model Regulation.

Asset Adequacy Testing of Reserves

To the extent required by law, regulation, or regulatory requirements, reserves established for equity indexed annuity policies must be tested for adequacy using appropriate methods and assumptions.
ATTACHMENT 1
Description of Computational Methods

CARVM-UMV

Step 1: For each duration and each benefit at which an index-based benefit is available, determine the market value of the appropriate call option. The appropriate call option is one that exactly hedges the floor of the benefit at that point in time. This means that the payoff of the call option should exactly equal the difference between the specific benefit available at that point in time (reflecting all relevant contract features) and the guaranteed floor of that benefit. The market value should be determined using an appropriate option pricing technique, such as Black-Scholes or a stochastic scenario method.

Step 2: The market value of all of the call options are projected forward at the appropriate valuation interest rate to the point in time at which the call option would expire. The valuation interest rate should be consistent with the requirements of any applicable Actuarial Guidelines or regulations, such as Actuarial Guideline XXXIII or Actuarial Guideline IX-B.

Step 3: The future guaranteed benefits for each benefit at each time point are determined by adding the guaranteed floors of the benefit to the amounts determined in Step 2.

Step 4: Now a CARVM calculation can be performed. The CARVM calculation should be in accordance with Actuarial Guideline XXXIII and any other applicable regulations or Actuarial Guidelines.

MVRM

Step 1: Calculate the projected index value at the end of the “term” which would produce a benefit at the end of the “term” equal to the sum of (1) the contract guarantee at that time, and (2) the current market value of the call option(s) which would fully hedge the index-based benefit, accumulated at the appropriate valuation interest rate. This calculation should be performed assuming equal annual percentage increases in the index. The call options used are those with maturity dates coterminous with the setting of participation rates, spread, or any other method of determining index-based benefits. The valuation interest rate used to accumulate the call options should be consistent with the requirements of any applicable Actuarial Guidelines or regulations, such as Actuarial Guideline XXXIII or Actuarial Guideline IX-B. Note that the “term” referred to above should be consistent with the “term” described in this Actuarial Guideline.

Step 2: From the current level of the index and the projected level of the index at the end of the term, calculate an implied compound constant growth rate of the index from the valuation date to the end of the term. Use this implied growth rate to project the level of the index at intermediate anniversaries.

Step 3: All annuity benefits can now be determined from the index levels.

Step 4: Now a CARVM calculation can be performed. The CARVM calculation should be in accordance with Actuarial Guideline XXXIII and any other applicable regulations or Actuarial Guidelines.

MVRM Using Black-Scholes Projection Method

This is an adaptation of the basic MVRM approach to accommodate products for which the participation rate, spread, or any other benefit determination method is redetermined during the term (particularly annually).

Step 1: Calculate the cost of a full hedging call option as a percentage of the account value for the period that the benefit determination is guaranteed, accumulate the percentage to the end of that period at the risk-free interest rate, and use the accumulated percentage cost as the projected growth rate of the account value during the period. Perform the same type of calculation for each successive period within the term,
giving recognition to the benefit guarantees, forward interest rates, forward index volatility, and index dividend levels.

Step 2: Determine the index level which would provide the projected account level on each anniversary on the basis of the participation rate, spread, or other benefit determination method used.

Step 3: All annuity benefits can now be determined from the index levels.

Step 4: Now a CARVM calculation can be performed. The CARVM calculation should be in accordance with Actuarial Guideline XXXIII and any other applicable regulations or Actuarial Guidelines.

EDIM

Step 1: The Fixed Component at issue is the formula reserve produced by either CARVM-UMV or MVRM. The Fixed Component at the end of the term is the floor of the benefit actually being hedged.

Step 2: The intermediate values of the Fixed Component are found by solving for an interest rate that would accumulate the initial value to the ending value. For example, assume you purchase options assuming that 90% of policyholders will surrender at maturity, and that 10% of policyholders will annuitize at maturity. The Fixed Component is the sum of (1) 90% of the Fixed Component that grows to the floor of the surrender benefit; and (2) 10% of the Fixed Component that grows to the floor of the annuitization benefit.

Step 3: The Equity Component is equal to the discounted intrinsic value of the options. The discounted intrinsic value of the options is found by taking the intrinsic value at the valuation date, and discounting at the valuation rate for the number of years from the valuation date to the end of the term. The valuation interest rate used to discount the intrinsic value of the call options should be consistent with the requirements of any applicable Actuarial Guidelines or regulations, such as Actuarial Guideline XXXIII or Actuarial Guideline IX-B.

Step 4: The reserve is the sum of a Fixed Component and an Equity Component.
In order to use a Type 1 computational method, the appointed actuary needs to certify quarterly that it meets either the “Basic” or “Option Replication” criteria.

**Basic**

1. Required equivalence of characteristics between the option contracts held and the options imbedded in the products with respect to specific contract features such as: Index, averaging features, option type, strike price, term, etc.

2. The amount of hedge purchased, at or near the contract issuance, must be greater than or equal to a Specified Percentage of the product’s account value, at contract issuance. The Specified Percentage varies by the length of the option guarantee (some annual ratchet products may have a term of several years, but the participation rates are only guaranteed for one year, so the “term” for this purpose is 1 year), and allows the company to assume no more than 3% per year of elective benefit decrements, unless the Commissioner agrees to a higher limit. For example, for a five-year point-to-point product, the Specified Percentage would be: \( SP\% = (1 - .03)^5 = 86\% \).

3. The Company must have a specific plan for hedging risks associated with interim death benefits, early surrenders, etc.

4. The Company must have a system in place that is used to monitor the effectiveness of the company’s hedging strategy.

5. The Company must have a stated maximum tolerance for differences between the expected performance of the hedge and the actual results of the hedge.

**Option Replication**

1. Required equivalence of characteristics between the target of an option replication strategy employed, and the options imbedded in the liabilities with respect to specific contract features such as: index, averaging features, option type, strike price, term, etc.

2. At the end of each quarter, the notional amount of the target of the option replication strategy must be greater than or equal to the sum of the Specified Percentages of each contract's account value. The Specified Percentage varies by the length of the remaining option guarantee (some annual ratchet products may have a term of several years, but the participation rates are only guaranteed for one year, so the “term” for this purpose is 1 year), and allows the company to assume no more than 3% per year of elective benefit decrements, unless the Commissioner agrees to a higher limit. For example, if a point-to-point contract has five years remaining, the Specified Percentage for that contract would be: \( SP\% = (1 - .03)^5 = 86\% \). Appropriate assumptions for non-elective decrements such as mortality may be added to the assumption for elective decrements.

3. The company must have a specific plan for hedging risks associated with interim death benefits, early surrenders, etc.

4. The Company must have system in place that is used to monitor the effectiveness of the company’s hedging strategy.

5. The Company must have a stated maximum tolerance for differences between the expected performance of the hedge and the actual results of the hedge. The maximum tolerance test and compliance evaluation test must meet the following minimum requirements. The compliance evaluation criteria will be a retrospective correlation test performed at least on a weekly basis.
The Company will compare the change in the market value, from the beginning of the calendar quarter, of the hedge portfolio with the change in the market value of the options embedded in the liability portfolio. The maximum dollar amount of difference permitted between these two changes is 10% of the beginning of period market value of the options embedded in the liabilities. If the difference exceeds this limit, the following steps must be taken:

- If for a second time during a quarter the dollar amount of difference exceeds 10% of the beginning of period market value of the options embedded in the liabilities, but is less than 25% of the beginning of period market value of the options embedded in the liabilities, the Company must notify the Commissioner of Insurance in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy.

- If at any of the weekly intervals, the difference between the two changes exceeds 25% of the beginning of period market value of the options embedded in the liabilities, the Company must notify the Commissioner of Insurance in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy and the impact on surplus of reporting the reserves based on the CARVM-UMV.

- If at any point in time during the quarter the difference between the two changes exceeds 35% of the beginning of period market value of options embedded in the liabilities, the insurer is deemed to be out of compliance with the "Hedged as Required" criteria, and the Company must notify the Commissioner of Insurance in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy and the impact on surplus of reporting the reserves based on the CARVM-UMV.

Drafting Note: The requirements discussed above deal with the situation in which the actual hedge underperforms relative to the expected hedge performance. The ability of an insurer to over-hedge may be constrained by other components of a state’s regulatory framework including the state’s investment article and regulations concerning the use of derivative instruments. For purposes of this Drafting Note, over-hedged means that at a particular point in time, the hedge portfolio exceeds the portfolio of liabilities being hedged. If over-hedged, the excess hedging instruments are excluded from the measurements required in Item 5 of the Hedged as Required Criteria.
ATTACHMENT 3
Reasonableness of Assumptions Certification

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The certification must be signed by the appointed actuary.

I, (state name and professional designation), am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity options used in the determination of the initial statutory reserves under the Enhanced Discounted Intrinsic Method for all equity indexed deferred annuity products issued or reinsured by (company name) and reported in the statutory financial statement as of (the date of valuation). The assumptions used to determine such option market values are reasonable in light of the relevant economic conditions prevalent at the time of issue of each policy valued using the Enhanced Discounted Intrinsic Method.

__________________________________________  
(Name of actuary)

__________________________________________  
(Signature of actuary)

__________________________________________  
(Date of certification)
ATTACHMENT 4
Reasonableness and Consistency of Assumptions Certification

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The certification must be signed by the appointed actuary.

I, (state name and professional designation), am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity options used in the determination of statutory reserves for all equity indexed annuity products issued or reinsured by (company name) insurance company and reported in the statutory financial statement as of (the date of valuation). The assumptions used to determine such option market values are:

1. reasonable in light of current relevant economic conditions as of the date of valuation, and
2. are consistent with the comparable assumptions used to determine the statement value of any derivative instruments used to hedge the equity indexed based obligations embedded in the equity indexed annuities subject to this certification

__________________________________________
(Name of actuary)

__________________________________________
(Signature of actuary)

__________________________________________
(Date of certification)
The purpose of this Actuarial Guideline is to clarify statutory and regulatory requirements for the valuation of reserves for equity indexed universal life insurance policies. This Guideline codifies the interpretation of the Commissioners Reserve Valuation Method (CRVM) by clarifying the computational methodologies that are deemed to comply with the intent of the Standard Valuation Law (SVL) and the Universal Life Insurance Model Regulation. These methodologies will be deemed to be consistent with CRVM.

Equity indexed universal life insurance policies include interest credits that are a combination of a guaranteed interest rate and an interest rate based on a percentage of the increase in an equity index, such as the S&P 500. Currently, there are only a few products in the market and the product designs have been straightforward. As new product designs emerge, this Actuarial Guideline may have to be revised.

In order that all insurers issuing equity indexed universal life insurance policies establish reserves for statutory reporting purposes that are consistent with CRVM minimum statutory formula reserves, this Actuarial Guideline identifies a computational method deemed to be consistent when specific operational criteria called “Hedged as Required” criteria are met. In addition, two other computational methods are defined that are deemed to be consistent with CRVM in the event the “Hedged as Required” criteria are not met.

This Actuarial Guideline applies to all equity indexed universal life insurance policies, regardless of the date of issue, that are subject to CRVM and would otherwise be subject to the reserve requirements under the Universal Life Insurance Model Regulation.

Appointed Actuary. The appointed actuary, for purposes of this guideline, is the actuary appointed by the company’s board of directors to provide opinions in accordance with Standard Valuation Law and the model Actuarial Opinion and Memorandum regulation.

Credited. Index-based benefits will be considered to be credited when they are added to the fund and treated in the same manner as other interest credits to the fund.

Term. An index-based benefit crediting period.

Computational Methods

Computational methods deemed to be consistent with CRVM can be classified into three groups, Type 1 methods, Type 2a methods and Type 2 methods. The following computational method is considered a Type 1 method: the Implied Guarantee Rate Method (IGRM). Type 1 computational methods are deemed to be consistent with CRVM only if the “Hedged as Required” criteria are met. The following is considered a Type 2a method: the Commissioners Reserve Valuation Method with Updated Average Market Value (CRVM with UAMV). The following is considered a Type 2 method: the Commissioners Reserve Valuation Method with Updated Market Value (CRVM with UMV). For a complete description of these methods, consult Attachment 1.
The minimum reserve for equity indexed life insurance policies is the statutory reserve calculated under the Universal Life Insurance Model Regulation for an identical policy with no guaranteed index-based benefits. If the reserve produced by Type 1, Type 2a or Type 2, as appropriate, is greater than the minimum reserve, then that Type 1, Type 2a or Type 2 reserve is the minimum reserve.

Type 1 Methods

A Type 1 computational method is deemed to be consistent with CRVM if an insurer using the method complies with the “Hedged as Required” Criteria (Attachment 2) and provides a certification (Attachment 3) as to compliance with the criteria. The appointed actuary must sign the certification. The certification shall be provided with each annual and quarterly statutory financial statement filed with the appropriate insurance regulatory official in each state in which the insurer writes or reinsures equity indexed universal life insurance business.

For purposes of determining compliance with the “equivalence of characteristics” requirement in the “Hedged as Required” criteria, the current term of an equity indexed universal life insurance policy is one year or less. This should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.

The IGRM computational method is deemed to be consistent with CRVM under the following conditions:

1. The implied guaranteed rate for terms after the first, determined at issue using the method of Attachment 1, paragraph 3 of the IGRM method, is less than or equal to the appropriate maximum valuation interest rate.

2. Index-based benefit terms cannot be greater than one year. This should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.

3. The appointed actuary has demonstrated at time of filing or in conjunction with a change to a Type 1 Method, to the satisfaction of the regulatory officials in each state in which the insurer writes or reinsures equity indexed universal life insurance business, prior to the use of the IGRM that the requirements in (1) and (2) above have been met.

Type 2a Methods

A Type 2a computational method is deemed to be consistent with CRVM if an insurer using the method complies with Type 2a Prerequisite Criteria below, and provides Reasonableness and Consistency of Assumptions Certification (Attachment 4). The appointed actuary must sign the certification. The certification shall be provided with each annual and quarterly statutory financial statement filed with the appropriate insurance regulatory official in each state in which the insurer writes or reinsures equity indexed universal life insurance business.

Type 2a Prerequisite Criteria are as follows:

1. At issue, the policy satisfies (a) or (b) as follows:

   (a) The implied guaranteed rate for terms after the first, determined at issue using the method of Attachment 1, paragraph 3 of the CRVM with UAMV method, is less than or equal to the appropriate maximum valuation interest rate; or

   (b) Policies with identical renewal guarantees issued in three of the past five years would have satisfied condition 1 for the Type 1 method.

2. Index-based benefit terms cannot be greater than one year. This should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.
3. The appointed actuary has demonstrated at time of filing or in conjunction with a change to a Type 2a Method, to the satisfaction of the regulatory officials in each state in which the insurer writes or reinsures equity indexed universal life insurance business, prior to the use of the CRVM with UAMV that the requirements in (1) and (2) above have been met.

**Type 2 Methods**

The use of a Type 2 method is not conditioned upon the requirement to meet the “Hedged as Required” criteria or the Type 2a Prerequisite Criteria. However, an insurer using a Type 2 method must provide a certification (Attachment 5) signed by the appointed actuary with each annual and quarterly statutory financial statement filed with the appropriate insurance regulatory official in each state in which the insurer writes or reinsures equity indexed universal life insurance business. This certification deals with the assumptions underlying the option market values included in the calculation of reserves using a Type 2 method and the consistency in assumptions between these option market values and the statement value of any options owned by the insurer to support the equity indexed universal life insurance business being valued.

**Required Change in Method**

In the event an insurer that is using a Type 1 computational method for a block of business fails to meet the applicable “Hedged as Required” criteria, the required actuarial certification must disclose this fact. If the reason for failing the “Hedged as Required” criteria is not corrected within one quarterly financial reporting period of the initial disclosure of the failure in the actuarial certification, the insurer must choose to use a Type 2a or a Type 2 computational method for determining minimum statutory formula reserves for this block of business.

If, at a later date, the insurer can demonstrate to the satisfaction of its domiciliary commissioner that it is meeting the applicable “Hedged as Required” criteria, the insurer may, with the approval of the domiciliary commissioner, resume using a Type 1 computational method. In addition, the insurer must notify the appropriate regulatory official in each state in which the insurer does business subject to the change in computational method.

**Optional Change in Method**

An insurer using either a Type 1, Type 2a or Type 2 computational method for a block of business may, with the approval of its domiciliary commissioner and after notifying the appropriate regulatory official in all the other states in which the insurer writes this block of business, use a computational method of another type. If the change in computational methods involves a change from a Type 2 or Type 2a computational method to a Type 1 computational method the request to the domiciliary commissioner for approval of the change in method must be accompanied with a demonstration of compliance with the applicable “Hedged as Required” criteria. If the change in computational methods involves a change from a Type 2 computational method to a Type 2a or Type 1 computational method, the request to the domiciliary commissioner for approval of the change in method must be accompanied with a demonstration of compliance with the “Type 2a Prerequisite Criteria” or the requirements specified in the section captioned “Type 1 Methods.”

**Asset Adequacy Testing of Reserves**

To the extent required by law, regulation, or regulatory requirements, reserves established for equity indexed life policies must be tested for adequacy using appropriate methods and assumptions.
Attachment 1
Description of Computational Methods

Implied Guaranteed Rate Method (IGRM)

To use this computational method, companies must satisfy the “Hedged as Required” criteria, which are set out in Attachment 2. On the asset side, options will be held in accordance with the rules of the NAIC Accounting and Procedures Manual.

The following describes how the IGRM works:

1. Issue date calculations:

   Calculate an implied guaranteed rate, determined at issue, for the period of the initial term equal to: (a) the guaranteed interest rate for the period of the initial term; plus (b) the accumulated option cost expressed as a percent of the policy value to which the indexed benefit is to be applied. The accumulated option cost, determined at issue, is the option cost, which will provide the index-based benefit in excess of any other interest rate guarantee for the initial term, accumulated to the end of the term at the appropriate maximum valuation rate. The option cost should be as of the issue date.

   Calculate an implied guaranteed rate, determined at issue, for the terms after the first. The implied guaranteed rates for terms after the first term will be based on historical moving average option costs according to (3) below.

   Using the Universal Life Insurance Model Regulation, with the guaranteed interest rates equal to the implied guaranteed rates, calculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, and net premium for the policy based on guarantees at issue.

2. Valuation date calculations:

   Calculate the implied guaranteed rate for the current term based on the current term’s index-based benefit and the option cost at the start of the current term that will provide the indexed benefit, in excess of any other interest rate guarantee, for the current term. The method of calculating the current term implied guaranteed rate is the same as for calculating the rate for the initial term. The implied guaranteed rate for terms after the current is not recalculated as long as neither the interest rate guarantees nor the index-based benefit guarantee have changed. (If guarantees have improved, then the new implied guaranteed rates for future terms will be based on option costs determined at issue according to (3) below.)

   Continue the calculation of the reserve according to the Universal Life Insurance Model Regulation. Use the recalculated current term implied guaranteed rate and the implied guaranteed rate for future terms, as determined according to (3) below, when computing future guaranteed benefits at the valuation date. Do not recalculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, or net premium. This section should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.

   In determining reserves, the net premiums, as determined in Section 1 above, are payable over the period that benefits are projected to be available, but not beyond the end of the net premium payment period determined at issue.

3. Index-based benefit guarantees beyond the current term should be handled as follows:

   Calculate an implied guaranteed rate, determined at issue, for the terms after the current term equal to: (a) the guaranteed interest rate for the period of the term; plus (b) the accumulated
option cost expressed as a percent of the policy value to which the indexed benefit is to be applied. The accumulated option cost is the historical moving average cost of the option whose term begins at the beginning of the term, which will provide the index-based benefit in excess of any other interest rate guarantee for the term, accumulated for the length of the term at the appropriate maximum valuation rate.

The historical moving average cost of the option will be calculated based on the averages over the sixty months previous to the calendar year of issue of each of the following items: (a) 3% plus the annualized daily actual index volatility as the estimated implied volatility for a one year European At-The-Money option, e.g., if the average index volatility is 15%, the implied volatility for the base case option cost is 18%; (b) index dividend rate; and (c) risk free rate. The base case cost is for a one year European At-The-Money option and must be adjusted to the characteristics of the policy.

In those states that require, by regulation, that the policy valuation interest rates not exceed the “minimum guaranteed interest rate” in the policy, the “minimum guaranteed interest rate” for IGRM is the implied guaranteed rate.

Commissioners Reserve Valuation Method Updated Average Market Value (CRVM with UAMV)

To use this computational method, companies must satisfy the Type 2a Prerequisite Criteria. On the asset side, options will be held in accordance with the rules of the NAIC Accounting and Procedures Manual. Similarly, reinsurance reserve credit will be in accordance with the rules of the NAIC Accounting and Procedures Manual.

The following describes how the CRVM with UAMV works:

1. Issue date calculations:

   Calculate an implied guaranteed rate, determined at issue, for the period of the initial term equal to: (a) the guaranteed interest rate for the period of the initial term; plus (b) the accumulated option cost expressed as a percent of the policy value to which the indexed benefit is to be applied. The accumulated option cost, determined at issue, is the option cost that will provide the index-based benefit in excess of any other interest rate guarantee for the initial term, accumulated to the end of the term at the appropriate maximum valuation rate. The option cost should be as of the issue date.

   Calculate an implied guaranteed rate, determined at issue, for the terms after the first. The implied guaranteed rates for terms after the first term will be based on historical moving average option costs according to (3) below.

   Using the Universal Life Insurance Model Regulation, with the guaranteed interest rates equal to the implied guaranteed rates, calculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, and net premium for the policy based on guarantees at issue.

2. Valuation date calculations:

   When calculating the present value of future guaranteed policy benefits at the valuation date by projecting a fund equal to the greater of the Guaranteed Maturity Fund or the policy value, this fund should be projected to the end of the current term at the guaranteed interest rate and added to the accumulated option cost for the current term. The option cost should be determined as of the valuation date.

   The option should provide for the index-based benefit in excess of any other interest rate guarantee for the current term based on a fund equal to the greater of the Guaranteed Maturity
Fund or the policy value. The option cost should be accumulated to the end of the current term at the appropriate maximum valuation rate in accordance with the SVL.

This combined amount should then be projected forward using the implied guaranteed rates for future terms, as determined according to (3) below.

The implied guaranteed rates for terms after the current are recalculated on the valuation date. The implied guaranteed rates for future terms will be based on historical moving average option costs on the valuation date according to (3) below.

Do not recalculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, or net premium. This section should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.

In determining reserves, the net premiums, as determined in Section 1 above, are payable over the period that benefits are projected to be available, but not beyond the end of the net premium payment period determined at issue.

3. Index-based benefit guarantees beyond the current term should be handled as follows:

Calculate an implied guaranteed rate, determined either at issue or at a valuation date, for the terms after the current term equal to: (a) the guaranteed interest rate for the period of the term; plus (b) the accumulated option cost expressed as a percent of the policy value to which the indexed benefit is to be applied. The accumulated option cost is the historical moving average cost of the option whose term begins at the beginning of the term, which will provide the index-based benefit in excess of any other interest rate guarantee for the term, accumulated for the length of the term at the appropriate maximum valuation rate.

The historical moving average cost of the option will be set equal to the option cost calculated based on the averages of each of the following items over the sixty months previous to the calendar year of the determination date: (a) 3% plus the annualized daily actual index volatility as the estimated implied volatility for a one year European At-The-Money option, e.g. if the average index volatility is 15%, the implied volatility for the base case option cost is 18%; (b) index dividend rate; and (c) risk free rate. The base case cost is for a one year European At-The-Money option and must be adjusted to the characteristics of the policy.

In those states that require, by regulation, that the policy valuation interest rates not exceed the “minimum guaranteed interest rate” in the policy, the “minimum guaranteed interest rate” for CRVM with UAMV is the implied guaranteed rate.

CRVM with Updated Market Value (UMV) Method

CRVM with UMV applies the Universal Life Insurance Model Regulation to equity indexed life insurance policies using the following methods:

1. Issue date calculations:

When calculating the present value of future guaranteed policy benefits at issue by projecting fund values, the fund should be projected to the end of the initial term at the guaranteed interest rate and added to the accumulated option cost for the initial term. This combined amount should then be projected forward, using the policy guarantees to determine future death and endowment benefits. The option should provide for the indexed benefit in excess of any other interest rate guarantee for the initial term. The option cost should be as of the issue date. The option cost should be accumulated to the end of the initial term at the appropriate maximum valuation rate in
accordance with the SVL. Any index-based benefit guarantees beyond the initial term should be determined as described in (3) below.

Using this method of determining the present value of future guaranteed benefits, calculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, and net premium for the policy based on guarantees at issue.

2. Valuation date calculations:

When calculating the present value of future guaranteed policy benefits at the valuation date by projecting a fund equal to the greater of the Guaranteed Maturity Fund or the policy value, this fund should be projected to the end of the current term at the guaranteed interest rate and added to the accumulated option cost for the current term. The option cost should be determined as of the valuation date. This combined amount should then be projected forward, using the policy guarantees to determine future death and endowment benefits. The option should provide for the index-based benefit in excess of any other interest rate guarantee for the current term, based on a fund equal to the greater of the Guaranteed Maturity Fund or the policy value. The option cost should be accumulated to the end of the current term at the appropriate maximum valuation rate in accordance with the SVL. Any index-based benefit guarantees beyond the current term should be treated as described in (3) below. Do not recalculate the Guaranteed Maturity Premium, Guaranteed Maturity Fund, or net premium. This section should be interpreted consistently when a separate index-based benefit guarantee is made on each premium received.

In determining reserves, the net premiums, as determined in Section 1 above, are payable over the period that benefits are projected to be available, but not beyond the end of the net premium payment period determined at issue.

3. Index-based benefit guarantees beyond the current term should be handled as follows:

At the time of calculation, fund values projected to the end of the current term should be further projected to the end of the next term at the guaranteed interest rate. This should be added to the accumulated option cost for that term. This should be done successively for each subsequent term, using the appropriate option cost for each term. The option for each term should provide for the index-based benefit in excess of any other interest rate guarantee for the term. The cost for each option should recognize the current relevant economic condition on the calculation date and be priced as if the term began on that date. The option cost for each future term should be accumulated to the end of the term at the appropriate maximum valuation rate in accordance with the SVL.
In order to use a Type 1 computational method, the appointed actuary needs to certify quarterly that it meets either the “Basic” or “Option Replication” criteria.

**Basic**

1. Required equivalence of characteristics between the option policies held and the options embedded in the policies for the current term with respect to specific policy features such as: index; averaging features; option type; strike price; term; etc.

2. The amount of hedge owned must substantially cover the greater of the account value or reserve. “Substantially” is measured by the guarantees in the specific policy (some policies may have longer term guarantees than others), and allows the company to assume no more than 6% per year of elective benefit decrements, unless the Commissioner agrees to a higher limit. Benefit decrements due to charges in the policy should be taken into account in the same way as they are in the indexed interest formula in the policy (i.e., if indexed interest is credited on an average fund value, then it is the projected average fund value on each policy which should be hedged.)

3. The company must have a specific plan for hedging risks associated with death benefits, early surrenders, unexpected premium payment patterns, and other potentialities. This plan must be available at issue and updated at every valuation date, or as often as the valuation actuary requirements may warrant.

4. The company must have a system in place that is used to monitor the effectiveness of its hedging strategy.

5. The company must have a stated maximum tolerance for differences between expected performance of the hedge and the actual results of the hedge.

**Option Replication**

1. Required equivalence of characteristics between the target of an option replication strategy employed and the options imbedded in the liabilities for the current term with respect to specific policy features such as: index; averaging features; option type; strike price; term; etc.

2. At the end of each quarter, the notional amount of the target of the option replication strategy must substantially cover the greater of the account value or reserve. “Substantially” is measured by the guarantees in the specific policy (some policies may have longer term guarantees than others), and allows the company to assume no more than 6% per year of elective benefit decrements, unless the Commissioner agrees to a higher limit. Benefit decrements due to charges in the policy should be taken into account in the same way as they are in the indexed interest formula in the policy, (i.e., if indexed interest is credited on an average fund value, then it is the projected average fund value on each policy which should be hedged.)

3. The company must have a specific plan for hedging risks associated with death benefits, early surrenders, unexpected premium payment patterns and other potentialities. This plan must be available at issue and updated at every valuation date, or as often as the valuation actuary requirements may warrant.

4. The company must have a system in place that is used to monitor the effectiveness of the company’s hedging strategy.
5. The company must have a stated maximum tolerance for differences between the expected performance of the hedge and the actual results of the hedge. The maximum tolerance test and compliance evaluation test must meet the following minimum requirements. The compliance evaluation criterion will be a retrospective correlation test performed at least on a weekly basis. The company will compare the change in the market value, from the beginning of the calendar quarter, of the hedge portfolio with the change in the market value of the target of the option replication strategy. The maximum dollar amount of difference permitted between these two changes is 10% of the beginning of period market value of the target of the option replication strategy. If the difference exceeds this limit, the following steps must be taken:

- If for a second time during a quarter the dollar amount of difference exceeds 10% of the beginning of period market value of the target of the option replication strategy, but is less than 25% of the beginning of period market value of the target of the option replication strategy, the company must notify the Commissioner in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy.

- If at any of the weekly intervals the difference between the two changes exceeds 25% of the beginning of period market value of the target of the option replication strategy, the company must notify the Commissioner in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy and the impact on surplus of reporting the reserves based on CRVM with UMV, or CRVM with UAMV if the conditions for that method are satisfied.

- If at any point in time during the quarter the difference between the two changes exceeds 35% of the beginning of period market value of target of the option replication strategy, the insurer is deemed to be out of compliance with the “Hedged as Required” criteria, and the company must notify the Commissioner in each state in which the insurer is licensed. The notification must indicate the dollar amount of reserves being hedged by the option replication strategy and the impact on surplus of reporting the reserves based on the CRVM with UM, or CRVM with UAVM if the conditions for that method are satisfied.

The requirements discussed above deal with the situation in which the actual hedge underperforms relative to the expected hedge performance. The ability of an insurer to over-hedge may be constrained by other components of a state’s regulatory framework including the state’s investment article and regulations concerning the use of derivative instruments. For purposes of this Guideline, over-hedged mean that at a particular point in time, the hedge portfolio exceeds the portfolio of liabilities being hedged. If over-hedged, the excess hedging instruments are excluded from the measurements required in Item 5 of the Hedged as Required Criteria.
Attachment 3
Reasonableness of Assumptions Certification for Implied Guaranteed Rate Method

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The appointed actuary must sign the certification.

I, (state name and professional designation) am the appointed actuary for (company name). The company meets the Hedged as Required criteria for policies reserved under the Implied Guarantee Rate Method. I have reviewed the assumptions underlying the values assigned to all equity index options used in the determination of the implied guaranteed rate used in the calculation of reserves under the Implied Guaranteed Rate Method for all equity indexed universal life insurance policies issued or reinsured by (company name) and reported in the statutory financial statement as of (the date of valuation).

The assumptions at the start of the current term used to determine such option values for the current term are:

1. Reasonable in light of current relevant economic conditions at the start of the current term; and
2. Consistent with the comparable assumptions used to determine the statement of value of any derivative instruments as of the valuation date used to hedge the equity index-based obligations embedded in the equity indexed life policies subject to this certification.

The assumptions at issue used to determine equity index option values for terms subsequent to the current term are:

1. Determined in accordance with the Implied Guaranteed Rate Method
2. Based on quantitative data for the base case option (1-year European At-The-Money) of 3% plus ___._% average annualized daily actual volatility over the 60 months previous to the calendar year of issue.
3. Reasonably adjusted to reflect the following variances from the base case due to benefit design and capital market reasons (all material adjustments should be listed)
   a. skew adjustments
   b. _______________(to be described by appointed actuary)

4. Reliant on the following source(s) for assumptions not prescribed by this Actuarial Guideline:
   a. _______________(to be described by appointed actuary)

__________________________________________
(Name of actuary)

__________________________________________
(Signature of actuary)

__________________________________________
(Date of certification)
Attachment 4

Reasonableness and Consistency of Assumptions Certification for Commissioners Reserve Valuation Method with Updated Average Market Value

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The appointed actuary must sign the certification.

I, (state name and professional designation) am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity index options used in the determination of statutory reserves using a Type 2a computational method for all equity indexed universal life insurance policies issued or reinsured by (company name) insurance company and reported in the statutory financial statement as of (the date of valuation).

The assumptions used to determine such option values for the current term are:

1. Reasonable in light of current relevant economic conditions as of the date of valuation; and
2. Consistent with the comparable assumptions used to determine the statement of value of any derivative instruments as of the valuation date used to hedge the equity index-based obligations embedded in the equity indexed life policies subject to this certification.

The assumptions used to determine equity index option values for terms subsequent to the current term are:

1. Determined in accordance with the Commissioners Reserve Valuation Method with Updated Average Market Value
2. Based on quantitative data for the base case option (1-year European At-The-Money) of 3% plus ___% 60-month moving average annualized daily actual volatility
3. Reasonably adjusted to reflect the following variances from the base case due to benefit design and capital market reasons (all material adjustments should be listed)
   a. skew adjustments
   b. _______________(to be described by appointed actuary)
4. Reliant on the following source(s) for assumptions not prescribed by this Actuarial Guideline:
   a. _______________(to be described by appointed actuary)

__________________________________________
(Name of actuary)

__________________________________________
(Signature of actuary)

__________________________________________
(Date of Certification)
Attachment 5
Reasonableness and Consistency of Assumptions Certification
for Commissioners Reserve Valuation Method with Updated Market Value

The following certification must be filed in conjunction with each quarterly and annual statutory financial statement filed with the appropriate regulatory official in each state in which the insurer does business. The appointed actuary must sign the certification.

I, (state name and professional designation) am the appointed actuary for (company name). I have reviewed the assumptions underlying the values assigned to all equity index options used in the determination of statutory reserves using a Type 2 computational method for all equity indexed universal life insurance policies issued or reinsured by (company name) insurance company and reported in the statutory financial statement as of (the date of valuation). The assumptions used to determine such option values are:

1. Reasonable in light of current relevant economic conditions as of the date of valuation;
   and
2. Consistent with the comparable assumptions used to determine the statement of value of any derivative instruments as of the valuation date used to hedge the equity index-based obligations embedded in the equity indexed life policies subject to this certification.

____________________________________________________________________________
(Name of actuary)

____________________________________________________________________________
(Signature of actuary)

____________________________________________________________________________
(Date of Certification)
VARIABLE LIFE INSURANCE RESERVES FOR GUARANTEED MINIMUM DEATH BENEFITS

Background

This guideline’s primary focus is to clarify the appropriate projection assumptions and methodologies used to determine statutory reserve liabilities for Guaranteed Minimum Death Benefits (GMDBs) offered with variable life insurance products.

For many years, insurance companies have not applied uniform reserve standards to variable life insurance policies in general, and to GMDBs in particular. Four regulatory sources are often looked to for guidance. First, the Standard Valuation Law (SVL) requires that CRVM be based on the present value of future guaranteed benefits. Second, the Variable Life Insurance Model Regulation as revised in 1983 and again in 1989 states “Reserve liabilities for variable life insurance policies shall be established under [SVL] in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.” Third is the Universal Life Insurance Model Regulation and most recently the Valuation of Life Insurance Policies Model Regulation.

GMDBs are common features of variable life products. Recently, reserve methods for universal life secondary guarantees have been clarified in the Valuation of Life Insurance Policies Model Regulation. These secondary guarantees are similar to GMDBs offered with variable life policies. A Guaranteed Minimum Death Benefit is any guarantee which provides death benefit protection which would not otherwise be provided in the absence of such a guaranteed benefit or provision. An example of a GMDB is a policy in which death benefits continue in-force even if the policy value is zero. This benefit may be contingent on additional qualifications being met, such as cumulative premiums meeting some limit.

Additional examples of GMDBs are provided below. This list is not intended to include all types of GMDBs.

- A Minimum Death Benefit Provision or No Lapse provision where death benefits are guaranteed to remain in-force for a period of time even if the policy value is not greater than zero subject only to certain conditions being met such as cumulative premiums meeting a minimum amount, or if a theoretical policy value is sufficient to meet a minimum amount.

- Death Benefits that are guaranteed to be at least as large as the original face amount, regardless of investment performance which might generate negative Paid Up Additions on a traditional fixed premium variable life insurance policy.

The Variable Life Insurance Model Regulation defines the reserve methodology for variable life policies. However, currently two versions of the model regulation exist and this results in inconsistent treatment by state. These two versions include the 1983 revisions and the 1989 revisions to the model regulation. Many states have not passed either revision and therefore require direct interpretation of SVL. In practice, companies have interpreted these regulations inconsistently with regard to assumptions and/or application to current products available today. The 1983 version of the regulation treats flexible premium policies differently than scheduled premium policies. The 1983 version of the regulation did not anticipate the types of GMDBs available today which require contingent conditions to be met to maintain a death benefit guarantee, for instance specified premiums must be paid. Thus, confusion exists with regard to which valuation method is appropriate. The 1989 version makes no distinction between the scheduled premium and flexible premium policies.
This Guideline codifies the basic interpretation of reserve liabilities for variable life GMDBs by clarifying the projection assumptions and methodologies that comply with the SVL. Minimum valuation standards that may be used to determine this reserve and are not specifically addressed in this guideline are defined by SVL and other applicable state regulations. This guideline focuses on the methodology of the 1989 revisions to interpret SVL, as we believe the 1989 revision more appropriately considers the types of products and GMDBs available today.

Interpretations of both the 1983 and 1989 versions reflect the comments made in the December 1972 report which concluded that an acceptable GMDB reserve system should have the following characteristics:

1. The GMDB reserve should be held in the general account of the company so that it will be backed by the general assets of the company, most of which are debt obligations valued at amortized cost and, therefore, are of a fixed dollar nature. It would not be proper to hold the GMDB reserve in the separate account, assuming the reserve is not supported by fixed dollar assets but by assets that are moving in the opposite direction from the risk, i.e. value moving downward while the risk increases and vice versa.

2. The GMDB reserve should be adequate to cover the GMDB death claims for the next year in all but the most extreme circumstances so that the regulatory authorities can be assured the company will not run into financial trouble from this source before the next annual statement is filed.

3. The GMDB reserve should react slowly but steadily through an extended period of poor investment experience of the separate account.

4. The GMDB reserve should not cause unnecessary fluctuations in surplus by increasing too rapidly in a sharp market downswing. Also, the reserve should not decrease too rapidly in a sharp market upswing after a period of poor market performance.

This guideline maintains the four principles above in interpreting the Standard Valuation Law as it relates to variable life business and the methods defined in both the 1983 and 1989 versions of the Variable Life Insurance Model Regulation.

Reserve methodologies which recognize the variable nature of GMDB are defined in the Variable Life Insurance Model Regulation and include a One-Year Term reserve recognizing a 1/3 drop in separate account assets, the Attained Age Level Reserve (AALR) methodology and in the 1983 version, a methodology for flexible premium policies. Reserves for GMDBs are held in the general account.

This guideline recognizes the following principles when determining appropriate reserves for GMDB.

- Determine the guaranteed death benefits which are not valued in the basic policy reserves.
- Establish a reserve for these benefits over the period of time in which revenue is collected to pay for such benefits; however, no greater than the period of time these guaranteed benefits are provided.
- Collected revenue should not be de-minimus in order to reduce the reserve.
- The reserve established is in addition to basic reserves.

This guideline interprets the standards for applying these methodologies. This guideline also interprets the projection assumptions to be applied to determine excess guaranteed death benefits. The guideline clarifies the use of the AALR methodology for flexible premium variable life policies with contingent
GMDB benefit structures similar to specified premium contracts. This guideline is based on the belief that the 1983 revisions did not anticipate these types of GMDB benefits on flexible premium contracts. Thus, it makes sense to interpret the 1983 revisions for these types of GMDB benefits by applying the AALR methodology when there is a contingent GMDB structure. For flexible premium plans with other types of GMDBs, the flexible premium language of the 1983 revision is used where applicable.

The AALR methodology, along with the one-year term reserve is generally consistent with the principles above in that additional reserves are established in recognition of all death benefit guarantees not reflected in basic reserves. If multiple guarantees exist all guarantees must be valued and the greatest additional reserve is held. Consecutive GMDBs are treated as a single guarantee. These reserves are funded over the period of time GMDB Revenue will be collected through either policy charges or premiums, however, not to exceed the GMDB benefit period. The AALR methodology funds any GMDB Revenue deficiency over the period of time the Revenue is collected, however, no longer than the end of the guarantee period.

GMDB reserves are held in addition to basic reserves unless the appointed actuary provides satisfactory documentation to the state of domicile insurance department stating why such reserves are redundant. For example, for traditional variable life product designs where reserves are generally determined on a tabular basis and use an assumed interest rate (AIR), if basic reserves are determined based on at least the guaranteed face amount, (i.e. ignoring any negative additions) then the guaranteed death benefit is fully reflected in the basic reserves; therefore, an additional GMDB reserve is redundant. Neither this guideline nor the 1989 amendments specifically address traditional variable life product designs, nor does this guideline specifically exclude these designs from its scope.

An additional purpose of this guideline is to emphasize the impact of Sections 3A(3) and 3A(4) in the Valuation of Life Insurance Policies Model Regulation (“XXX”) relative to reserving for variable life and variable universal life products.

Scope

The guideline applies to all variable life insurance contracts to which the Standard Valuation Law applies and which provide Guaranteed Minimum Death Benefits (GMDBs) either explicitly or implicitly.

Definitions

**Attained age level reserve (AALR):** The AALR is a methodology described in the 1983 and 1989 revisions to the Variable Life Insurance Model Regulation.

**Catch-up provision:** A Catch-up provision is a provision in the policy that gives the policyholder the right to catch up on any contingent requirements in order to maintain the GMDB.

**Guaranteed Period:** The guaranteed period is the period of time over which a GMDB is guaranteed regardless of the basic guarantees in the policy. A policy may have multiple guaranteed periods and GMDBs.

**Guaranteed Minimum Death Benefit (GMDB):** A Guaranteed Minimum Death Benefit (GMDB) is any guarantee which provides continued death benefit protection which would not otherwise be provided in the absence of such a guaranteed benefit or provision. A policy may have multiple GMDBs.

**One-Year Term (OYT) reserve:** The OYT reserve covers a period of no more than one year following a 1/3–asset drop. This reserve is fully described in the 1989 revision to the Variable Life Insurance Model Regulation. This guideline clarifies the methodology and the assumptions used to determine OYT reserves.
Policy Value: Policy value means, as of the valuation date, the greater of (a) zero and (b) the amount to which separately identified interest credits and/or investment return and mortality, expense, or other charges are made under a variable life insurance policy. Subsequent to the valuation date, "policy value" means the amount determined in accordance with the procedures specified in this guideline.

Projection Assumptions: The Projection Assumptions are used to determine guaranteed death benefits. This projection of policy values uses the following assumptions:

1. Cost of insurance rates are equal to the minimum valuation mortality.

2. The GMDB is assumed to be in effect for the maximum period of the GMDB. All minimum requirements necessary to maintain the GMDB in force subsequent to the valuation date are assumed to be met at the latest point in time sufficient to maintain the GMDB through its maximum period. Contingent requirements, if any, required to reinstate or catch-up as of the valuation date are assumed to occur on the valuation date. If the GMDB would continue in effect subsequent to the valuation date with no additional actions required, contingent requirements are assumed not to resume until the latest point in time which would prevent the termination of the GMDB.

3. The general account policy values and separate account policy values are projected at the valuation interest rate. The assumed investment rate, if any, is used when determining the OYT reserve.

4. The guaranteed period covered is determined assuming all contingent requirements are met.

5. Policy options and benefits are assumed to continue unchanged as of the valuation date. Examples include fixed and variable account allocation and the death benefit option.

6. The projection of policy values is made for the entire guarantee period, regardless of whether projected policy values are positive or negative at any point in the projection. Any negative policy value would be set to zero.

The policy value is projected forward from the valuation date with valuation interest rate credits, any payments required to maintain the guarantee and valuation mortality charges (and no other credits or charges). The Guideline stipulates that “A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero,” and “Any negative policy value would be set to zero.” An AALR need not be established for a VUL policy to provide for any period during which there would be a death benefit in the absence of the guarantee, since this benefit would be provided for by the policy’s basic reserve. This means that for an AALR to develop, the mortality charges must exceed the required payments plus interest credits by enough to reduce the policy value to zero during the guarantee period. Surrender charges are not relevant to this determination.

GMDB Revenue: GMDB Revenue is policy charges or premium, either implicit or explicit. These charges or premiums may or may not be explicitly stated to cover GMDB benefits. An example of an implicit premium is a positive premium necessary to maintain a target policy value in order to maintain benefits.

Term cost: Term costs are based on the guaranteed minimum death benefits in excess of the death benefits that would be provided in absence of such guarantee based on a projection of policy values using the Projection Assumptions defined above. These costs are then discounted to the valuation date. The term costs are based on minimum valuation mortality standards and a discount rate not to exceed the maximum valuation interest rate.

1/3-Asset Drop: A 1/3 reduction in separate account assets that is used in the calculation of the one-year term reserve. This 1/3 drop is not applied to fixed account assets.
Text

1. **Basic Reserves:**

Basic Reserves include the reserve held for death benefits provided in the absence of a GMDB. Reserve liabilities for variable life insurance policies shall be established consistent with the methodologies described in the Standard Valuation Law and in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees. Reserve methods described in the Variable Life Insurance Model Regulation and the Universal Life Insurance Model Regulation may be appropriately utilized to determine reserve liabilities such that application of these methods is consistent with the principles of the Standard Valuation Law.

2. **Guaranteed Minimum Death Benefit Reserves:**

Additional reserves are required to provide for liabilities of GMDB provisions which provide benefits that would not be provided in the absence of the guarantee. In measuring these liabilities, the basic reserve provides for death benefits which occur in the absence of the guarantee. GMDB reserves provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in absence of the guarantee. A consistent reserve methodology should be used regardless of whether a contract has scheduled premiums or flexible premiums.

When a contract provides multiple GMDBs and/or multiple guarantee periods, a reserve is established based on the guaranteed period which produces the greatest reserve as of the valuation date. Consecutive GMDBs are treated as a single guarantee period. The reserve methodology reflects all potential guarantee periods assuming that contingent requirements are met such as: contingent premiums paid, Catch-up Provisions or any pre-funding of contingent requirements.

For a policy under the 1989 revisions or a flexible premium policy with contingent GMDBs similar to a specified premium contract under the 1983 revision, the GMDB reserve equals the greater of (1) and (2) where (1) equals “the aggregate total of term costs” (OYT) which covers a period of no more than one year following a 1/3-Asset Drop, and (2) equals the AALR as described below.

For a flexible premium policy under the 1983 revisions not covered above, (where the GMDB guarantee is not contingent on any policyholder requirement), reserve liabilities for any guaranteed minimum death benefit shall be maintained in the general account of the insurer and shall be not less than the aggregate total of the term costs, if any, covering the period provided for in the guarantee not otherwise provided for by the reserves held in the separate account assuming a 1/3-asset drop, projected at the valuation interest rate.

a) **One Year Term Reserves (OYT):**

This reserve component equals the “aggregate total of term costs”, if any, covering a period of one full year from the valuation date, or, if less, covering the period of time death benefits are provided which are not otherwise provided for by the basic reserves. This reserve assumes any contingent requirements to maintain the GMDB are met by reflecting any Catch-up Provisions or any pre-funding of contingent requirements.

“Aggregate total term costs” equals the present value of guaranteed minimum death benefits in excess of death benefits that would be provided in absence of such guarantee, if any, prior to the end of one full year or the end of the guaranteed period if sooner. A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero. Death benefits are determined by projecting the policy value following a 1/3 -Asset Drop and using the Projection Assumptions
defined above. Present values are determined using valuation mortality rates and the maximum valuation interest rate.

b) Attained Age Level Reserves (AALR):

This reserve component allows for funding GMDBs over no longer than the guaranteed period. This reserve assumes contingent requirements are met to maintain the GMDB and reflect any prepaid contingent requirements or Catch-up provisions. A death benefit in the absence of the guarantee is assumed to be provided as long as the projected policy value is greater than zero. This reserve component exists until no later than the end of the guarantee period if, on any prior valuation date, projected policy values resulted in guaranteed minimum death benefits in excess of death benefits that would be provided in absence of such guarantee. To the extent long term favorable investment performance results in redundant reserves, the valuation actuary may request permission from the state of domicile insurance department to release all or a portion of the redundant GMDB reserves. This projection of policy value is based on the Projection Assumptions defined above and does not incorporate a 1/3-Asset Drop.

The AALR reserve component shall not be less than zero and shall equal the “residue,” as described in paragraph (1) below, of the prior year’s AALR on the contract, with any such “residue,” increased or decreased by a “payment” computed on an attained age basis as described in paragraph (2) below.

(1) The “residue” of the prior year’s AALR on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the maximum valuation interest rate to such prior year’s reserve, deducting the tabular claims based on the “excess”, if any, of the guaranteed minimum death benefit over the death benefit that would be payable in absence of such guarantee, and dividing the result by the tabular probability of survival. Hence, tabular costs are only deducted for years where, in the absence of the guarantee, coverage would be less than the guaranteed coverage.

(2) The “payment” used to increase or decrease the “residue” above shall be computed so that the present value of a level payment of that amount each year over the future period for which GMDB Revenue will be collected under the contract is equal to (A) minus (B) minus (C), where, (A) is the present value of future guaranteed minimum death benefits. The future guaranteed minimum death benefits are the projected future death benefits including the GMDB. (B) is the present value of the projected future death benefits that would be payable in the absence of the GMDB. The guaranteed benefit for (A) and (B) should be calculated for the life of the policy. Both (A) and (B) are calculated based on the Projection Assumptions. (C) is any “residue,” as described in paragraph (1) above, of the prior year’s AALR on such variable contract. Minimum standards of valuation mortality assumptions and maximum valuation interest rates are used to determine present values and net level payments. The period of time in which GMDB Revenue will be collected is limited to the period of time policy values are sufficient to collect policy charges or the period of time contingent requirements will be paid to maintain the GMDB. In no event will the time period be greater than the time to the end of the guarantee period. It should also be noted that the “payment” may be negative resulting in the reserve running off over the remaining guarantee period.
c)  Other Flexible Premium Policies under the 1983 revisions not included above:

   The present value of potential guaranteed minimum death benefits in excess of death
   benefits that would be provided in absence of such guarantee is determined by using
   minimum standards of valuation mortality assumptions and maximum valuation interest
   rates.

3.  Issues:

   Sections 3A(3) and 3A(4) of “XXX” state the following:

   3A(3):  This regulation shall not apply to any variable life insurance policy that provides for life
   insurance, the amount or duration of which varies according to the investment experience of any
   separate account or accounts.

   3A(4):  This regulation shall not apply to any variable universal life insurance policy that
   provides for life insurance, the amount or duration of which varies according to the investment
   experience of any separate account or accounts.

   The language of these sections is clear. The reserving for variable life and variable universal life
   is in no way affected by the provisions of “XXX.” In particular, the 19-year select factors and the
   “X” factor are not applicable to the calculation of reserves for variable life and variable universal
   life products.

Effective Date

   This guideline affects all variable life insurance contracts issued. Where the application of this Guideline
   produces higher reserves than the company had otherwise established by their previously used
   interpretation, such company must comply with this guideline effective December 31, 2001. However,
   such company may request a grade in period, not to exceed three (3) years, from the domiciliary
   Commissioner upon satisfactory demonstration of the previous interpretation and that such delay of
   implementation will not cause a hazardous financial condition or potential harm to its policyholders.

   Retroactive application of the guideline to in-force policies to develop the current residue portion of the
   AALR will generally not be feasible. Therefore, the residue as of 12/31/2000 should be set equal to the
   greater of the amount established by the company under its current method or $0 if the company did not
   previously calculate an AALR.
Actuarial Guideline XXXVIII

THE APPLICATION OF THE VALUATION OF LIFE INSURANCE POLICIES
MODEL REGULATION (“MODEL”)

Introduction

The revised version of the Model was adopted by the NAIC in March 1999. Since that date, some questions have been raised regarding whether and how the Model applies to various product designs. The purpose of this guideline is to provide direction as to the application of the Model to such products. Specifically, this guideline provides examples of various policy features that constitute “guarantees” and gives directions on how to reserve for these guarantees in accordance with the Model.

Obviously, new policy designs will emerge subsequent to the development of this document. No statute, regulation, or guideline can anticipate every future product design, and common sense and professional responsibility are needed to assure compliance with both the letter and the spirit of the law. While the Model is a complex regulation, its intent is clear: reserves need to be established for the guarantees provided by a policy. Policy designs which are created to simply disguise those guarantees or exploit a perceived loophole must be reserved in a manner similar to more typical designs with similar guarantees.

Text

The following product designs have been brought to the attention of the NAIC’s Life and Health Actuarial Task Force. The list below specifies reserving approaches which the Task Force regards as being most consistent with the letter and spirit of the Model. However, the specified reserving approaches should be modified as needed to comply with the intent of this guideline that similar reserves be established for policy designs that contain similar guarantees.

1. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, the company cannot increase premiums after year 10 (i.e., the initial premium continues to be charged) unless some specified event occurs.

The initial reserve segment is 30 years. Since the contract contains provisions that limit the company’s ability to increase premiums, then the initial premium should be treated as guaranteed for the entire 30 year period. It would be contrary to the conservative nature of statutory accounting to treat this policy the same as one in which the ability to raise premiums is unrestricted.

2. A term policy has an illustrated level premium for 30 years, the first 10 of which are guaranteed. Additionally, there is a refund option which provides that a specified refund will be paid if the premium ever increases. The refund must be requested within a limited time (e.g., 30 days) of receiving notice of the increase. Coverage terminates if the option is exercised.

This example differs from the one above in that there is no specified event that has to occur in order for the company to impose a premium increase; however, the company must provide an additional benefit to the policyholder if it exercises this right. Thus the company does not have an unrestricted right to impose an increase after 10 years. If the contract contains provisions that require that additional benefits be provided to the policyholder in the event of a premium increase, even if these benefits are lost if not claimed within a stated time frame, then the initial premiums should be treated as guaranteed for the entire 30 year period. It would be contrary to the conservative nature of statutory accounting to treat this policy the same as one in which the ability to raise premiums does not require that additional benefits be provided. Therefore, the initial segment for this policy is 30 years.
3. An initial level premium rate is guaranteed for 10 years followed by increased guaranteed premiums for an additional 20 years. However, after year 10 the policyholder is protected against premiums being increased above the initial level, with the protection provided by a second company through either reinsurance, a second policy issued to the consumer, or an agreement between the companies.

The combined reserves of the direct writer and the second company should be no less than the amount which the direct writer would hold if a) there were no second company and b) the initial reserve segment were 30 years. If this condition is not met, reserve credits for the direct writer should be disallowed. The reserve held by the direct writer should be based on the initial level premium being guaranteed for 30 years.

4. A product has relatively high gross premiums but with a guaranteed dividend or guaranteed refund schedule, or by some other means guarantees a low net cost to the policyholder.

The net amount of premium (i.e., gross premium less dividends or refunds) should be used in the reserve calculation. That represents the amount the insured actually pays for coverage.

For products reinsured on either a coinsurance or modified coinsurance basis, the reinsurer’s reserve calculation should also be based on the net premium (i.e., gross premiums less dividends or refunds guaranteed to be paid to the policyholder).

5. a) A re-entry term product has an initial rate guarantee for 10 years, with loose or non-existent re-entry underwriting, allowing the policyholder to re-enter for an additional 20 years at specified favorable rates. b) A universal life policy has provisions such that, if the UL policy lapses prior to the 10th policy anniversary because the actual accumulation value (or cash value, depending on design) falls below zero but stipulated premiums have been paid, a substitute policy is guaranteed to be issued providing the same amount of insurance coverage at the same stipulated premium for the remainder of the 10-year period plus an additional 20 years.

The reentry periods and premiums should be treated as a continuation of the initial guarantees for reserve calculation purposes. The initial reserve segment applicable to the original policy should be 30 years if the stipulated premium for the substitute policy is not high enough to trigger a new reserve segment. When the substitute policy is issued, reserves should be determined as if the coverage had been issued at the issue age and issue date of the original policy. Effectively, the company has guaranteed coverage for 30 years at the time the initial policy is issued, and the reserves established should reflect that guarantee.

6. A reinsurance treaty provides for 30 years of level premiums on a current scale but directly guarantees those premiums for only the first 10 years. However, if the reinsurer increases the premiums after 10 years, the reinsurer agrees to increase the expense allowance such that the net payments (premium minus allowance) by the direct writer remains unchanged.

Relative to the reinsurer’s reserve calculation, the initial reserve segment should be 30 years and the valuation premium should be level over that period. In this instance, the additional “expense allowance” has no relationship to the expenses actually incurred by the direct writer in administering the reinsured policies. Although a bona fide expense allowance would typically not be considered in determining the valuation premiums and reserve segments, in this instance the additional “expense allowance” has no relationship to the expenses actually incurred by the direct writer in administering the reinsured policies.”
7. A universal life policy has a cumulative “premium catch-up provision” in which the coverage is guaranteed to remain in force as long as a stipulated premium is paid each year, and if the insured is paying less than is required to maintain the guarantee, there is an unlimited right to make up past premium deficiencies.

XXX requires that “when a policy contains more than one secondary guarantee, the minimum reserve shall be the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees.” Since secondary guarantees with “catch-up” provisions are capable of being reinstated up to the end of the secondary guarantee period, they constitute “unexpired secondary guarantees” which must be incorporated into the calculation of “the greatest of the respective minimum reserves at that valuation date of each unexpired secondary guarantee, ignoring all other secondary guarantees.”

The basic and deficiency reserves for a secondary guarantee with a catch-up provision should be computed as if the stipulated premium requirement had been met. The basic reserve shall be reduced by the product of a) the “catch-up amount,” if any, which would be required on the valuation date and b) the ratio of the “initial” (i.e., before adjustment) basic reserve to the sum of the “initial” basic and deficiency reserves. In no event shall the “reduced” basic reserve be reduced below zero. The deficiency reserve shall be reduced by the product of a) the “catch-up amount,” if any, which would be required on the valuation date and b) the ratio of the “initial” deficiency reserve to the sum of the “initial” basic and deficiency reserves. In no event shall the “reduced” deficiency reserve be reduced below zero.

If a universal life policy with a “premium catch up provision” has a shadow account below the level necessary to maintain the secondary guarantee, then the reserve for the secondary guarantee shall be valued according to this example. The basic and deficiency reserves, before deduction for the catch-up amount, shall be calculated as specified in Example #8.

8A. For policies and certificates issued prior to July 1, 2005: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of the Model, the “specified premiums” are the minimum gross premiums derived in “Step One.”

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, a determination should be made of the single payment necessary at the valuation date to fully fund the remaining secondary guarantee assuming that the minimum gross premiums have been paid, up through the valuation date, during the secondary guarantee period. The result from “Step Three” should be divided by this number.
Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of the Model.

Sixth, the “net amount of additional premiums” is determined by multiplying the ratio from “Step Four” by the difference between the net single premium from “Step Five” and the basic and deficiency reserve, if any, computed in “Step Two.”

Seventh, a “reduced deficiency reserve” should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from “Step Four,” but not less than zero. This “reduced deficiency reserve” is the deficiency reserve to be used for purposes of Section 7D(1).

Eighth, the actual reserve used for purposes of Section 7D(1) is the lesser of: (1) the net single premium from “Step Five,” and (2) the amount of the excess from “Step Six” plus the basic reserve and the deficiency reserve, if any, computed in “Step Two.” Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. If the resulting amount is less than the sum of the basic and deficiency reserve from Step #2, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) are those calculated in Step #2, and no further calculation is required.

Ninth, an “increased basic reserve” should be computed by subtracting the “reduced deficiency reserve” in “Step Seven” from the reserve computed in “Step Eight.” This “increased basic reserve” is the basic reserve to be used for purposes of Section 7D(1).

8B. For policies and certificates issued on or after July 1, 2005 and on or prior to December 31, 2006 and on or after January 1, 2014: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of the Model, the “specified premiums” are the minimum gross premiums derived in “Step One.” Consistent with the Model, the remaining steps in this guideline should be calculated on a segmented basis, using the segments that the Model defines for the product. Therefore, in the remaining steps, the term “fully fund the guarantee” should be interpreted to mean fully funding the guarantee to the end of each possible segment. The term “remainder of the secondary guarantee period” should be interpreted to mean the remainder of each possible segment. The total reserve should equal the greatest of all possible segmented reserves.

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, as of the valuation date for the policy being valued, for policies utilizing shadow accounts, determine the minimum amount of shadow account required to fully fund the guarantee. For policies with no shadow accounts but which specify cumulative premium requirements, determine the amount of the cumulative premiums paid in excess of the cumulative premium requirements that would result in no future premium requirements to fully fund the
guarantee; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee). For any policy for which the secondary guarantee can not be fully funded in advance, solve for the minimum sum of any possible excess funding (either the amount in the shadow account or excess cumulative premium payments depending on the product design) and the present value of future premiums (using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves) that would fully fund the guarantee. The amount determined above for this step is to then be divided by one minus a seven percent premium load allowance (0.93). The result from “Step Three” should be divided by this number, with the resulting ratio capped at 1. The ratio is intended to measure the level of prefunding for a secondary guarantee which is used to establish reserves. Assumptions within the numerator and denominator of the ratio therefore must be consistent in order to appropriately reflect the level of prefunding. The denominator is allowed to be inconsistent only by the amount of the premium load allowance as defined in this step. As used here, “assumptions” include any factor or value, whether assumed or known, which is used to calculate the numerator or denominator of the ratio.

[DRAFTING NOTE: The 7% premium load allowance approximates an average premium load level as evidenced by policies currently sold in the market. Rather than have the funding ratio vary according to the actual policy loads (which can fluctuate greatly by company and product), all companies will use an identical premium load allowance at a level approximately equal to the current industry average.]

Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of the Model.

Sixth, the “net amount of additional premiums” is determined by multiplying the ratio from “Step Four” by the difference between the net single premium from “Step Five” and the basic and deficiency reserve, if any, computed in “Step Two.”

Seventh, a “reduced deficiency reserve” should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from “Step Four,” but not less than zero. This “reduced deficiency reserve” is the deficiency reserve to be used for purposes of Section 7D(1).

Eighth, the actual reserve used for purposes of Section 7D(1) is the lesser of: (1) the net single premium from “Step Five,” and (2) the amount of the excess from “Step Six” plus the basic reserve and the deficiency reserve, if any, computed in “Step Two.” Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. Multiply this surrender charge by the ratio of the net level premium for the secondary guarantee period divided by the net level premium for whole life insurance. Calculate both net premiums using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves. However, if no future premiums are required to support the guarantee period being valued, there is no reduction for surrender charges. If the resulting amount is less than the sum of the basic and deficiency reserve from Step #2, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) are those calculated in Step #2, and no further calculation is required.

Ninth, an “increased basic reserve” should be computed by subtracting the “reduced deficiency reserve” in “Step Seven” from the reserve computed in “Step Eight.” This “increased basic reserve” is the basic reserve to be used for purposes of Section 7D(1).
For all policies and certificates issued on or after January 1, 2007 and on or prior to December 31, 2013: A universal life policy guarantees the coverage to remain in force as long as the accumulation of premiums paid satisfies the secondary guarantee requirement.

First, the minimum gross premiums (determined at issue) that will satisfy the secondary guarantee requirement must be derived.

Second, for purposes of applying Sections 7B and 7C of the Model, the “specified premiums” are the minimum gross premiums derived in “Step One.” Consistent with the Model, the remaining steps in this guideline should be calculated on a segmented basis, using the segments that the Model defines for the product. Therefore, in the remaining steps, the term “fully fund the guarantee” should be interpreted to mean fully funding the guarantee to the end of each possible segment. The term “remainder of the secondary guarantee period” should be interpreted to mean the remainder of each possible segment. The total reserve should equal the greatest of all possible segmented reserves. Additionally, for purposes of applying Sections 7B and 7C of the Model, a lapse rate of no more than 2% per year for the first 5 years, followed by no more than 1% per year to the policy anniversary specified in the following table based on issue age, and 0% per year thereafter may be used. If the duration in the table is less than 5, than a lapse rate of no more than 2% per year may be used through that duration, and 0% per year thereafter.

<table>
<thead>
<tr>
<th>Issue Age</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-50</td>
<td>30th policy anniversary</td>
</tr>
<tr>
<td>51 - 60</td>
<td>Policy Anniversary age 80</td>
</tr>
<tr>
<td>61 – 70</td>
<td>20th policy anniversary</td>
</tr>
<tr>
<td>71 - 89</td>
<td>Policy anniversary age 90</td>
</tr>
<tr>
<td>90 and over</td>
<td>no lapse</td>
</tr>
</tbody>
</table>

Third, a determination should be made of the amount of actual premium payments in excess of the minimum gross premiums. For policies utilizing shadow accounts, this will be the amount of the shadow account. For policies with no shadow accounts but which specify cumulative premium requirements, this excess will be the amount of the cumulative premiums paid in excess of the cumulative premium requirements; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee).

Fourth, as of the valuation date for the policy being valued, for policies utilizing shadow accounts, determine the minimum amount of shadow account required to fully fund the guarantee. For policies with no shadow accounts but which specify cumulative premium requirements, determine the amount of the cumulative premiums paid in excess of the cumulative premium requirements that would result in no future premium requirements to fully fund the guarantee; the cumulative premium payments and requirements should include any interest credited under the secondary guarantee (with interest credited at the rate specified under the secondary guarantee). For any policy for which the secondary guarantee can not be fully funded in advance, solve for the minimum sum of any possible excess funding (either the amount in the shadow account or excess cumulative premium payments depending on the product design) and the present value of future premiums (using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves) that would fully fund the guarantee. The amount determined above for this step is to then be divided by one minus a seven percent premium load allowance (0.93). The result from “Step Three” should be divided by this number, with the resulting ratio capped at 1. The ratio is intended to measure the level of prefunding for a secondary guarantee which is used to establish reserves. Assumptions within the numerator and denominator of the ratio therefore must be consistent in order to appropriately reflect the level of prefunding. The denominator is allowed to be inconsistent only by the amount.
of the premium load allowance as defined in this step. As used here, “assumptions” include any factor or value, whether assumed or known, which is used to calculate the numerator or denominator of the ratio.

[DRAFTING NOTE: The 7% premium load allowance approximates an average premium load level as evidenced by policies currently sold in the market. Rather than have the funding ratio vary according to the actual policy loads (which can fluctuate greatly by company and product), all companies will use an identical premium load allowance at a level approximately equal to the current industry average.]

Fifth, compute the net single premium on the valuation date for the coverage provided by the secondary guarantee for the remainder of the secondary guarantee period, using any valuation table and select factors authorized in Section 5A of the Model. For purposes of calculating the net single premium, a lapse rate subject to the same criteria as the lapse rate used in applying Step 2 of 8C above may be used.

Sixth, the “net amount of additional premiums” is determined by multiplying the ratio from “Step Four” by the difference between the net single premium from “Step Five” and the basic and deficiency reserve, if any, computed in “Step Two.”

Seventh, a “reduced deficiency reserve” should be computed by multiplying the deficiency reserve, if any, by the one minus the ratio from “Step Four,” but not less than zero. This “reduced deficiency reserve” is the deficiency reserve to be used for purposes of Section 7D(1).

Eighth, the actual reserve used for purposes of Section 7D(1) is the lesser of: (1) the net single premium from “Step Five,” and (2) the amount of the excess from “Step Six” plus the basic reserve and the deficiency reserve, if any, computed in “Step Two.” Reduce this result by the applicable policy surrender charges, i.e., the account value less the cash surrender value. Multiply this surrender charge by the ratio of the net level premium for the secondary guarantee period divided by the net level premium for whole life insurance. Calculate both net premiums using the maximum allowable valuation interest rate and the minimum mortality standards allowable for calculating basic reserves. If the resulting amount is less than the sum of the basic and deficiency reserve from Step #2, then the basic and deficiency reserves to be used for the purposes of Section 7D(1) are those calculated in Step #2, and no further calculation is required.

Ninth, an “increased basic reserve” should be computed by subtracting the “reduced deficiency reserve” in “Step Seven” from the reserve computed in “Step Eight.” This “increased basic reserve” is the basic reserve to be used for purposes of Section 7D(1).

Business reserved pursuant to Section 8C must be supported by an asset adequacy analysis specific to this business. This asset adequacy analysis must be performed pursuant to the requirements of Section 3 of the Standard Valuation Law. Reserves required by Section 8C shall be increased by any additional reserves required by the asset adequacy analysis.
Effective Date

With the exception of “Step Three” through “Step Nine” of Item #8A and all of Items #8B and #8C, the application of this guideline shall be retroactive to the earlier of a state’s adoption of the revised Model or the statutory accounting practices and procedures as set forth in the NAIC Accounting Practices and Procedures Manual. All of Items #8A, #8B and #8C shall be applicable to policies and certificates issued on or after the later of the date of a state’s adoption of the revised Model and January 1, 2003, subject to the dates specified in Items #8A, #8B and #8C.
RESERVES FOR VARIABLE ANNUITIES WITH GUARANTEED LIVING BENEFITS

I. Background

The purpose of this Actuarial Guideline (Guideline) is to interpret the standards for the valuation of reserves for guaranteed living benefits included in variable deferred and immediate annuity contracts (VAGLBs). This Guideline provides an interpretation of the National Association of Insurance Commissioners’ (NAIC) Model Standard Valuation Law (SVL) for VAGLBs and is intended to be temporary.

The methodology does not specifically address how “base variable annuity reserves” (i.e., reserves for variable annuity contracts calculated by ignoring VAGLBs) should be calculated. Rather, it only addresses the calculation of reserves for VAGLBs to be held in the General Account.

In addition, this Guideline interprets the standards for the valuation of reserves when the VAGLB risk is reinsured.

II. Scope

This Guideline applies to variable deferred and immediate annuity contracts that provide one or more guaranteed living benefits. This Guideline does not apply to those group annuity contracts that are not subject to the Commissioners’ Annuities Reserve Valuation Method (CARVM).

VAGLB designs falling under the scope of this Guideline include, but are not limited to, currently offered provisions commonly referred to as Guaranteed Minimum Accumulation Benefits (GMABs), Guaranteed Minimum Income Benefits (GMIBs), Guaranteed Minimum Withdrawal Benefits (GMWBs), and Guaranteed Payout Annuity Floors (GPAFs).

III. Text

A. Aggregate Reserves for Contracts with VAGLBs

The Aggregate Reserves for Contracts with VAGLBs are the total reserves held by the company in support of the variable annuity contracts with VAGLBs, and equals the sum of 1 and 2, where:

1. equals the aggregate reserves for the variable annuity contracts ignoring both the future revenues and benefits from the VAGLBs and after comparison to the cash value of the contracts. For the purpose of determining future revenues and benefits for VAGLBs, a charge should be imputed in the event that there are no explicit VAGLB charges.

and

2. equals the VAGLB reserve, determined as the sum of the aggregate VAGLB charges from the date of issue to the valuation date for VAGLB benefits in-force (i.e., contracts still in-force and still eligible for the VAGLB), the sum reduced by 2.5% each calendar quarter beginning January 1, 2008 and subject to the asset adequacy analysis requirement in subsection C (i.e., each quarter the prior quarter VAGLB result is multiplied by 0.975 then the VAGLB charges from the quarter are added to the product). In the event that there are no explicit VAGLB charges, a charge should be imputed.

The VAGLB reserve must be held in the General Account. (This is in addition to any amounts in item 1 that are required to be held in the General Account).
B. Reserve for Ceded and Assumed Reinsurance

If all or a portion of the VAGLB risk is reinsured on a proportional basis, the ceding company is entitled to a corresponding proportional reinsurance reserve credit based on the VAGLB reserve held before consideration of reinsurance.

Adjustments may need to be made to the reserve credit taken by ceding companies where the underlying reinsurance treaty contains non-proportional elements.

For companies where VAGLB risk is assumed, the aggregate VAGLB reserves for contracts with VAGLBs will be the sum of a) the aggregate direct VAGLB charges in proportion to the amount of reinsurance from the issue date of the contract to the effective date of the reinsurance contract and b) gross reinsurance premiums from the effective date of the reinsurance contract to the valuation date for VAGLB benefits in force (i.e. contracts still in force and eligible for the VAGLB) and subject to the asset adequacy analysis requirement in subsection C.

C. Asset Adequacy Analysis Requirement

The appointed actuary must perform a standalone asset adequacy analysis of the VAGLB reserve. If such analysis reveals a reserve shortfall, VAGLB reserves must be increased. Such analysis shall be performed reflecting the following:

1. all VAGLB benefits and expenses,

2. all VAGLB charges, and

3. the assets supporting the VAGLB reserves.

The analysis shall be performed on an aggregate basis for all contracts with VAGLBs, consistent with the requirements of the NAIC Model Actuarial Opinion and Memorandum Regulation, including the requirement that the analysis conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board. However, no separate actuarial opinion is required by this Actuarial Guideline.

Where the VAGLB is reinsured, the asset adequacy analysis may reflect the reinsurance. However, if the inclusion of reinsurance in the asset adequacy analysis would increase the VAGLB reserve, then reinsurance must be reflected in the analysis.

IV. Applicability

This Guideline is effective December 31, 2002 and affects all contracts issued on or after January 1, 1981.

Since the requirements of this Guideline are intended to be temporary, this Guideline is in effect until no later than December 30, 2009.
GUIDELINE FOR VALUATION RATE OF INTEREST FOR FUNDING AGREEMENTS AND
GUARANTEED INTEREST CONTRACTS (GICS) WITH BAIL-OUT PROVISIONS

PURPOSE

The purpose of this Guideline is to interpret the Standard Valuation Law (SVL) for assignment of appropriate valuation interest rates to risks embedded in bail-out provisions under Funding Agreements and Guaranteed Interest Contracts.

BACKGROUND

Funding Agreements (FAs) and other types of Guaranteed Interest Contracts (GICs) typically issued to tax-exempt municipal bonds, money market funds and securities lending funds, often contain bail-out provisions that allow the contractholders to get their money back at full book value. Such provisions may be triggered by the credit rating downgrade of the issuer below a given level or may be at a given period’s notice to the contractholder, e.g. 7, 30, 90 or 180 days’ notice. The contract language for these provisions may be as follows:

1. In the event that the investment provider (i.e. the insurance company) is downgraded below A-/A3 by S & P and/or Moody’s respectively, the contract holder has the right to terminate the contract and receive the remaining principal and accrued interest without penalty. [In most cases the issuer has the alternate option to provide a replacement contract or post collateral or do a credit wrap.]

2. Each party has the right to terminate the contract before maturity by giving the other at least 7/30/90 or 180-days notice in writing. At such termination the principal and accrued interest is payable with no penalty.

Contracts with downgrade provision

The bulk of the contracts issued with a downgrade provision are fixed rate FAs or GICs issued in connection with tax-exempt municipal bonds. These contracts can be short-term or long-term. Short-term contracts typically have an average life of around one-year, and are intended for municipal bond funds for construction, acquisition, housing, tax revenue anticipation notes (TRANS), etc. In these types of funds the cash-flow projections are provided when the case is underwritten, but there may be variability in the actual withdrawals. Any outstanding principal and interest is payable at maturity.

Long-term contracts are issued in connection with the debt service reserve (DSR) or the float fund of the bond issue, and mature at the same time as the bonds, which can be as long as 30 years. The float fund takes in deposits, and pays out the half-yearly interest and principal (if any is due) on the bonds. It runs to near zero about twice a year, after each half-yearly coupon payment. The DSR is a contingent fund for a rainy day to prevent a missed coupon or principal payment on the bond. The DSR has a single deposit that is typically 10% of the bond issue.

Contracts with put provision

FAs or GICs with put provisions are generally issued to money market funds subject to Rule 2a-7 of the Investment Company Act. Rule 2a-7 provides guidelines on liquidity, requiring funds available at book value subject to certain notification periods. Additionally, these contracts usually have downgrade provisions. Even if the downgrade provision is not in the contract, it can be assumed that the put will be exercised on downgrade, since a certain level of credit is also a Rule 2a-7 requirement.
Typically, these FAs or GICs guarantee a floating rate of interest linked to an index like LIBOR, which is paid out and reset periodically. Most contracts have fixed maturity dates when the principal is returned. Generally the FAs or GICs are the higher yielding assets of the money market funds, and therefore puts are not expected to be exercised.

**Risks**

Both the downgrade and the put provisions present liquidity or concentration type of risks to the issuer, i.e. if a critical event occurs, a substantial part of the whole block of business is likely to be liquidated. Sufficient asset liquidity, prudent A/L management, cash flow testing, hedging strategies, etc. can mitigate these risks. Also, companies generally have contractual provisions providing alternative options.

**Downgrade provision:**

The main risk here is that, upon downgrade to the trigger level, a company may have to realize its assets at a market loss in order to pay out at book. If the downgrade happens in a falling interest rate environment there is no risk of a market loss as the underlying assets are likely to be at a higher market value. On the other hand if the downgrade occurs in a rising interest rate environment, market value losses would occur when the company sells assets to pay out liabilities at book value.

Companies have written provisions in their contracts that provide alternate options to paying at book value in a rising interest rate environment:

- **“Novation/Assignment” option:** The novation/assignment option allows the company to transfer its liabilities to another funding agreement provider that meets the credit rating requirements of the contractholder. In a rising interest rate environment, the new provider should be willing to pay a “premium” to assume a liability crediting a below market interest rate. In a perfectly efficient market this “premium” should precisely offset the market value loss upon the sale of the asset. In practice, however, it is less likely that the “premium” would fully offset the market value loss since:
  - The new provider may view the liability risk somewhat differently
  - The new provider may try and take advantage of the situation of the downgraded company
  - There may be a large volume of these types of contracts in the market, etc.

However, the “premium” payable by the new provider could provide a substantial offset against the market value loss incurred by the downgraded company.

- **“Collateralization” option:** This option allows the company to post assets as collateral for the benefit of the contractholder, as an alternative to payment at book value. The collateral posted would have to meet the credit requirements of the contractholder, which could be government or agency securities. Usually the collateral posted is required to have a cushion, typically ranging from 102% to 105%.

Upon trigger of the downgrade provision, the company would need to have suitable assets in its portfolio that are available for use as collateral, and also acceptable to the contractholder. In addition, there will be administrative and custodial expenses/fees of establishing and monitoring collateral levels. In some states there may also be legal restrictions on encumbering assets that back policyholder claims.

If the downgraded company can overcome the above constraints, then collateralization is another alternative of maintaining the contract and not having to pay out at book value.

- **“Credit Wrap” option:** Under this arrangement the contract is issued out of a separate account which is guaranteed by a financial guarantee insurer. Effectively, the credit rating of the guarantor passes through to meet the credit requirement of the FA or GIC. [A number of FAs or GICs requiring a higher credit rating are currently being written in this way.]
The contract being wrapped has to meet certain criteria before the financial guarantee insurers are willing to wrap. Generally, the guarantor would also require higher credit rated securities in the separate account, which could be government or agency, and would require these in the 102% to 105% range. There will also be administrative and custodial expenses of establishing and monitoring the separate account in addition to the wrap fee payable to the mono-line insurer.

Although at significant cost, this option does provide the downgraded company a viable alternative to paying out at book value.

Put provision:
The put provision is not tied to a particular event but can contractually be exercised by giving the required days’ notice. It has been argued that this provision is there to meet the Rule 2a-7 liquidity requirements and in practice is unlikely to be exercised, particularly since the FAs or GICs are one of the higher yielding assets of the money market portfolio. However, it is a contractual option and if, for example, the issuer were in financial difficulties, it will be exercised. Past experience suggests this is the case.

The put provision therefore presents a liquidity or concentration risk similar to that of downgrade—it is likely to be exercised in bulk upon happening of a critical event. Similar considerations apply, i.e. in a rising interest rate environment market value losses would occur when the company sells assets to pay out liabilities at book value.

Reserves

For reserving the Standard Valuation Law applies. However, when the SVL was enacted, these types of bail-out provisions did not exist, and were therefore not addressed explicitly. The purpose of this Guideline is to interpret the SVL for assignment of appropriate valuation interest rates to risks embedded in these bail-out provisions.

Other Actuarial Guidelines have provided similar interpretations. For example, Guideline XIII addresses interest bailout provisions under annuity contracts, Guideline XXX provides for participant directed withdrawal provisions under GICs, and Guideline XXXIII covers the elective and non-elective benefits under individual annuity contracts.

Plan Types

The SVL utilizes a concept known as Plan Type, which was designed to distinguish between the various levels of disintermediation risks—the greater the disintermediation risk for a company, the more conservative is the resulting valuation rate. Plan Types designated in the model SVL are defined as follows:

Plan Type A: At any time policyholder may withdraw funds only (1) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without such adjustment but in installments over five years or more, or (3) as an immediate life annuity, or (4) no withdrawal permitted.

Plan Type B: Before expiration of the interest rate guarantee, policyholder may withdraw funds only (1) with an adjustment to reflect changes in interest rates or asset values since receipt of the funds by the insurance company, or (2) without such adjustment but in installments over five years or more, or (3) no withdrawal permitted. At the end of interest rate guarantee, funds may be withdrawn without an adjustment in a single sum or installments over less than five years.

Plan Type C: Policyholder may withdraw funds before expiration of interest rate guarantee in a single sum or installments over less than five years either (1) without adjustment to reflect changes in interest
rates or asset values since receipt of the funds by the insurance company, or (2) subject only to a fixed surrender charge stipulated in the contract as a percentage of the fund.

**TEXT**

For the purpose of the application of the Standard Valuation Law to FAs and GICs, the annuities and GIC valuation interest rates are to be used. The bailout provisions described above shall be treated as a withdrawal by the policyholder at book value, and the underlying contracts shall be classified as Plan Type C.

However, for contracts containing written provisions that allow the insurance company alternate options to paying out at book value, the valuation actuary may use a valuation rate of interest higher than Type C. In no event may the valuation interest rate be greater than that applicable to similar contracts with no put or bailout provisions. If a provision requires over-collateralization and/or use of high credit quality assets, this should be adequately reflected in the reserves.

If a higher interest rate than Type C is used, the valuation actuary must be satisfied and be able to demonstrate that the written provisions substantially reduce the liquidity risk. In addition, the valuation actuary must be satisfied, and should periodically review, that there are other risk management measures in place to reduce the liquidity or concentration risk, taking into consideration at least the following:

- Readily liquidated assets at nil or minimal market-value loss
- Cash-flow testing results
- Standby lines of credit available and other liquidity facilities established
- Hedges in place with liquidity options
- High credit quality assets available for use as collateral.
Actuarial Guideline XLI

PROJECTION OF GUARANTEED NONFORFEITURE BENEFITS UNDER CARVM

I. Background

The following is an excerpt from the October 21, 2003, Report of the American Academy of Actuaries’ Life Valuation Subcommittee:

Annuity SNFL Impact on Reserves

Per the Standard Valuation Law, Commissioner’s Annuity Reserve Valuation Method (CARVM) is:

“the greatest of the respective excesses of the present values, at the date of valuation, of the future guaranteed benefits, including guaranteed nonforfeiture benefits, provided for by the contracts at the end of each respective contract year, over the present value, at the date of valuation, of any future valuation considerations derived from future gross considerations, required by the terms of the contract, that become payable prior to the end of the respective contract year.”

Historically the guaranteed nonforfeiture benefit calculation has been determined at issue (e.g. 90 percent of premiums accumulated at three percent interest). The recent change to the Standard Nonforfeiture Law for Individual Deferred Annuities has changed this.

Nonforfeiture Rate

The new Standard Nonforfeiture Law for Individual Deferred Annuities has changed the nonforfeiture rate from being static to being dynamic. Under the old law, the nonforfeiture interest rate was three percent. The revised law bases the nonforfeiture rate on the five-year Constant Maturity Treasury Rate less 125 basis points (bps). The nonforfeiture rate is subject to a minimum of one percent and a maximum of three percent. Additional enhancements include the ability to reset the nonforfeiture rate at a date predetermined in the contract and allowing an additional reduction (offset) for Equity Indexed Annuities.

The nonforfeiture rate can be reset at a date predetermined in the contract (e.g. five years from issue) and based on a formula specified in the contract. The same requirements applicable to the initial rate apply to the re-determined rate.

The revised law allows an additional offset to the nonforfeiture rate for contracts that provide substantive participation in an equity indexed benefit. This offset ranges from 0 bps to 100 bps.

The ability to re-determine the nonforfeiture rate and that the EIA offset may be reevaluated in the future raises some issues with the CARVM calculation.

In doing a CARVM projection, what should be the assumed interest rate? Should the option depend on whether there are re-determination provisions? Should the option depend on whether the product relies on an equity indexed offset?
The Report further states:

The minimum guaranteed interest rate in the contract might be different than the minimum nonforfeiture rate. To the extent that the guaranteed values in the contract are always greater than the minimum nonforfeiture benefits, then the nonforfeiture values do not come into play.

This Guideline specifies how to determine the nonforfeiture interest rate used in determining the minimum nonforfeiture benefits guaranteed under the contract. As noted in the Report, the minimum nonforfeiture benefits may be less the guaranteed values otherwise provided by the contract. Where this is the case, the higher guaranteed values are used in the CARVM calculation, and “the nonforfeiture values do not come into play.”

It should also be noted that requirements for projecting guarantees exist in other regulations and guidelines, such as the specifications in Actuarial Guideline XXXV (“The Application of the Commissioners Annuity Reserve Method to Equity Indexed Annuities”) for projecting equity-indexed guarantees. The specifications of this Guideline are in addition to any other requirements.

II. Scope

This Guideline applies to contracts subject to CARVM and the Standard Nonforfeiture Law for Individual Deferred Annuities (“SNLIDA”).

III. Text

The following assumptions shall be made on the valuation date for purposes of determining the future nonforfeiture interest rate when this rate is not known in advance. For purposes of (B) below, “NI” shall refer to the nonforfeiture interest rate, “VI” shall refer to the valuation interest rate, and “CNI” shall refer to the current nonforfeiture interest rate which will be adjusted for any future durations pursuant to “A” below.

A. For the period of time during which the additional EIA offset is not known, the additional offset shall be zero.

B. For the period of time during which the nonforfeiture interest rate is not known,
   \[ NI = \min \{\max \{VI, CNI\}, 3\%\} \]

If the redetermination of the nonforfeiture interest rate is based on changes to the value of the underlying index (this will be the five-year Constant Maturity Treasury Rate in the case of the nonforfeiture interest rate), then for purposes of this Guideline it shall be assumed that such rate is not known as of the first date on which the rate may be subject to redetermination.

IV. Applicability

This Guideline is effective December 31, 2006 and affects all contracts issued on or after January 1, 1981.
Actuarial Guideline XLII

THE APPLICATION OF THE MODEL REGULATION PERMITTING THE RECOGNITION OF PREFERRED MORTALITY TABLES FOR USE IN DETERMINING MINIMUM RESERVE LIABILITIES

1. **Purpose**

The purpose of this Guideline is to provide rules and guidance to appointed actuaries in the selection of the proper set of mortality rates when a company chooses to use the 2001 CSO Preferred Class Structure Mortality Table authorized under the Model Regulation Permitting The Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (herein after called the “Model”). All terms in this guideline specifically defined in the regulation will have the same definition as specified by the regulation.

2. **Effective Date and Scope**

The 2001 CSO Preferred Class Structure Mortality Table is available for valuation purposes for individual life policy forms (and certain group life products sold to individuals by certificate with premium rates guaranteed from issue for at least two years), issued on or after 1/1/2007, or, if later, the effective date of the state’s actual regulation based on the Model.

3. **Definitions**

A. “Anticipated mortality” means the appointed actuary’s assumption about the mortality to be experienced in the future on a group of insured lives.

B. “Appointed actuary” means any individual who is appointed or retained in accordance with the requirements set forth in the Actuarial Opinion and Memorandum Regulation.

C. “Basic reserves” means reserves calculated in accordance with Section 5 of the Standard Valuation Law.

D. “Class” means a group of policies under one or more plans of insurance that has similar anticipated mortality, as grouped together by the insurer.

E. “Credibility” means a measure of the predictive value in a given application that the appointed actuary attaches to a particular body of data (predictive is used here in the statistical sense and not in the sense of predicting the future).

F. “Deficiency reserves” means the excess over basic reserves, if any, of minimum reserves established in accordance with Section 8 of the Standard Valuation Law.

G. “Full credibility” means the level at which a particular body of data is assigned full predictive value based on a selected confidence interval.

H. “Preferred class certification” means the certification required by Section 5 of the Model.

I. “Underwriting-based justification” means the incorporation of underwriting criteria for use in setting the anticipated mortality assumption.

J. “Underwriting class” means the insurer’s designation of insureds into a particular premium rate structure, e.g. super preferred, preferred, or standard.
4. **Selection of Table within the 2001 CSO Preferred Class Structure Mortality Table**

Section 5 of the Model contains the requirements governing the set of mortality rates to be used for the purpose of calculating reserves based on the 2001 CSO Preferred Class Structure Mortality Table. The election of the 2001 CSO Preferred Class Structure Mortality Table is on a policy form and calendar year of issue basis, although once a calendar year cohort of policy forms is placed on the 2001 CSO Preferred Class Mortality Structure Table basis, it may not subsequently revert back to the standard 2001 CSO basis without the approval of the commissioner. This would be considered a basis change for annual statement reporting purposes. For those calendar years of issue in which a company opts to use the 2001 CSO Preferred Class Structure Mortality Table, it must use the entire 2001 CSO Preferred Class Structure Mortality Table for the chosen policy forms, i.e. a company may not use the preferred classes from the 2001 CSO Preferred Class Structure Mortality Table and use the Standard 2001 CSO Mortality Table for the non-preferred class(es). Additionally, if the company sells two similar policy forms in the same market the appointed actuary must use the same version of the table for both forms and may not use the 2001 CSO Preferred Class Structure Mortality Table on one and the Standard 2001 CSO Mortality Table on the other. A characteristic of this two-form scenario is that preferred lives would be attracted to one form and non-preferred lives would be attracted to the other.

The Model contains a requirement that at the time of election and annually thereafter, except for business valued under the Residual Standard Nonsmoker Table or the Residual Standard Smoker Table, the appointed actuary shall certify that the following tests of sufficiency were passed:

a. For each class, the present value of death benefits over the next ten years after the valuation date using the anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

b. For each class, the present value of death benefits over the future life of the contracts using anticipated mortality experience without recognition of mortality improvement beyond the valuation date for each class is less than the present value of death benefits using the valuation basic table corresponding to the valuation table being used for that class.

In the event that the class does not contain any policies with expiry dates ten or more years into the future, the sufficiency test based on the present value over the future life of the contracts shall be the only test required.

In order to choose the proper set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table and to develop the preferred class certification, the following considerations shall be made:

A. **Creation of Classes**

The appointed actuary should consider the composition and characteristics of the policies issued under a plan of insurance in determining the appropriate classes that will be applicable under that plan. The policies that comprise classes generally have similar underwriting or mortality experience characteristics. When classes are similar across various plans of insurance, these classes may be combined into a single aggregate class. The appointed actuary shall not combine classes that are expected to have dissimilar anticipated mortality as a means to produce reserves that are materially lower than those developed if the classes were not combined.
The appointed actuary should consider the presence of reinsurance in creating classes. Anticipated mortality should be assessed and classes should be created on a gross basis. To the extent that anticipated mortality on reinsurance ceded or assumed is materially different from that on direct business, the appointed actuary should consider creating separate classes to properly reflect the anticipated mortality.

If, due to differences in actual experience by policy form and underwriting class, groupings of classes are changed from those used in the prior actuarial certifications, the change and the effect of the change shall be disclosed to the commissioner in the actuarial certification.

Separate classes may be established for a single policy form if there are significant anticipated mortality differences for different cohorts of insured lives, such as age groups or policy sizes. For instance, if a company has different underwriting thresholds for policies with face amounts of $1 million or more, it may be appropriate to have a class for policies with face amounts of less than $1 million and a separate class for policies of $1 million or more.

B. Deriving Anticipated Mortality

i. If relevant company experience for a particular class is available and has full credibility, the appointed actuary shall use that experience as the basis for deriving anticipated mortality.

ii. In situations where relevant company experience for a particular class is available but does not have full credibility, the appointed actuary shall derive the anticipated mortality by blending the relevant company experience for the class with actual relevant, credible experience and past trends in experience of other similar types of business, either in the same company, in other companies (including reinsurance companies), or from other sources, generally in that order of preference provided that the appointed actuary supplies underwriting-based justification. The blending process shall be based on a credibility methodology that is recognized by the actuarial profession as acceptable practice as provided for in published transactions and scientific journals.

iii. In situations where relevant company experience for a particular class is not available (e.g. a new product), the appointed actuary may derive the anticipated mortality using actual relevant credible experience and past trends in experience of other similar types of business either in the same company, in other companies (including reinsurance companies), or from other sources, generally in that order of preference, provided that the appointed actuary supplies underwriting-based justification.

iv. Underwriting-based justification shall include an analysis of the relationship between the underwriting-based criteria for the class where no experience data is available or does not have full credibility and the underwriting-based criteria that underlie the actual relevant credible experience data.

v. If no sufficient underwriting-based or experienced-based justification is made to derive anticipated mortality for a class, the company shall not use the 2001 CSO Preferred Class Structure Mortality Table for valuation.
C. Periodic Assessment of Anticipated Mortality

The appointed actuary shall annually review relevant emerging experience and underwriting methods for the purpose of assessing the appropriateness of anticipated mortality for each class and, in aggregate, for all classes combined. If the results of statistical or other testing indicate that previously anticipated mortality for a given class is inappropriate, then the appointed actuary shall set a new anticipated mortality assumption for the class. After analyzing the appropriateness of the anticipated mortality for each class, the appointed actuary shall analyze the appropriateness of the anticipated mortality assumptions at the aggregate level. If the analysis at the aggregate level indicates that aggregate anticipated mortality is inadequate, then the appointed actuary shall adjust the anticipated mortality assumption for one or more of the classes until the appointed actuary is satisfied that the anticipated mortality assumptions are adequate at the aggregate level.

D. Tests of Sufficiency

After the anticipated mortality is established, each class must be tested for sufficiency. If a class fails any required sufficiency test, the class must be re-valued using a different set of mortality rates from the 2001 CSO Preferred Class Structure Mortality Table. A company must choose a set of mortality rates under which all required tests of sufficiency can be passed.

E. Calculation of Present Value

When a class is tested for sufficiency, the calculation of the present value of death benefits shall be based on a projection of death benefits, without the effect of lapse, at the valuation interest rate used to determine basic reserves for the class. If the class contains policies with several valuation interest rates, the lowest valuation interest rate used to determine the base reserves for any policy within the class shall be used for that class.

F. Right of Commissioner to Change the Table Used by the Company

The commissioner may require a company to change the mortality table if it is determined by the commissioner that inadequate justification of anticipated mortality is provided by the company.

5. Communications and Disclosures

The appointed actuary shall provide to the commissioner an annual certification that, as of the valuation date, the anticipated mortality experience of each Class of business (other than Residual Standard Class) meets the criteria of 4(a) and 4(b) above. Additionally, the appointed actuary shall prepare an annual report in support of the certification. The report shall include the following items:

A. The certification that the report supports;

B. The specified plans of insurance for which the company has elected to use the Preferred Class Structure Table, briefly describing each plan and the amount of in force business (count, face amount, and reserves) on each plan on the valuation date;

C. Compliance with the certification criteria;
D. Description of sources of information used as a basis for determining anticipated mortality;
E. Analysis performed to evaluate the credibility of relevant historical company experience when establishing anticipated mortality for each Class;
F. Analysis performed to evaluate the relationship between the underwriting-based criteria and the anticipated mortality established in each class.
G. Statistical or other quantitative analyses performed in assessing the continued appropriateness of the anticipated mortality assumption for each Class and for all Classes in aggregate, and a summary of changes made as a result of the analyses;
H. Anticipated Mortality, without recognition of mortality improvement beyond the date of valuation, for each Class and for all Classes in aggregate;
I. For each Class, the ratio of Anticipated Mortality to the mortality rates in the Valuation Basic Table corresponding to the set of valuation mortality rates being used for that Class;
J. Any changes made in the approach or parameters applied to the statistical analyses or tests performed compared to those performed at the last annual valuation; and,
K. Disclosure of the financial impact of any change in the chosen set of valuation mortality rates

Drafting Note: Annual actuarial opinions, certifications and reports for the use of “X” factors have been required since the implementation of the NAIC’s Valuation of Life Insurance Model Regulation. The work and analysis to be performed for Preferred Class Certification is very similar to the requirements for the use of the “X” factors and the appointed actuary may combine the selection and analysis of “X” factors and the selection and analysis of 2001 CSO Preferred Class Structure Mortality Table into one actuarial opinion, certification and annual experience report, if the appointed actuary wishes to do so.

6. Other Items of Note

A. If a class of business is assigned to a different set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table (either a higher or lower level of mortality rates) from that used in the prior valuation, the change is not considered a basis change, and the reserve change must be accounted for in the calculation of gain from operations.
B. Multiple underwriting classes on a policy form can be mapped into the same set of mortality rates within the 2001 CSO Preferred Class Structure Mortality Table, if, in aggregate, the underwriting classes can be shown to have anticipated mortality no greater than the valuation basic table underlying the set of mortality rates selected.
C. If a company chooses to use the 2001 CSO Preferred Class Structure Mortality Table for basic reserves, the same table must be the basis for the calculation of deficiency reserves.
Section I) Background

The purpose of this Actuarial Guideline (Guideline) is to interpret the standards for the valuation of reserves for variable annuity and other contracts involving certain guaranteed benefits similar to those offered with variable annuities. The Guideline codifies the basic interpretation of the Commissioners Annuity Reserve Valuation Method (CARVM) by clarifying the assumptions and methodologies that will comply with the intent of the Standard Valuation Law (SVL). It also applies similar assumptions and methodologies to contracts that contain characteristics similar to those described in the scope, but that are not directly subject to CARVM.

For many years regulators and the industry have struggled with the issue of applying a uniform reserve standard to these contracts and in particular some of the guaranteed benefits referenced above. Current approaches make assumptions about product design, contractholder behavior and economic relationships and conditions. The economic volatility seen over the last few decades, combined with an increase in the complexity of these products, have made attempts to use these approaches for measuring economic-related risk less successful.

The Guideline addresses these issues by including an approach that applies principles of asset adequacy analysis directly to the risks associated with these products and guarantees.

The NAIC is currently using a similar approach to calculate risk-based capital (RBC) for similar contracts (i.e., the C-3 Phase II project). The methodology in the Guideline is based on that approach, and the intent of the Guideline is to, where possible, facilitate a framework whereby companies may determine both reserve and RBC in a consistent calculation.

In developing the Guideline, two regulatory sources were looked to for guidance. First, the SVL requires that CARVM be based on the greatest present value of future guaranteed benefits. Second, the NAIC Model Variable Annuity Regulation (VAR) states that the “reserve liability for variable annuities shall be established pursuant to the requirements of the Standard Valuation Law in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.”
The Guideline requires that reserves for contracts falling within its scope be based on a minimum floor determined using a standard scenario (referred to as the Standard Scenario Amount) plus the excess over this minimum floor, if any, of a reserve calculated using a projection of the assets and estimated liabilities supporting these contracts over a broad range of stochastically generated projection scenarios and using prudent estimate assumptions (referred to as the Conditional Tail Expectation Amount). Within each of these scenarios, the greatest of the present values of accumulated losses ignoring Federal Income Tax is determined. The assumed fund performance for these scenarios must meet the mandated calibration standards contained in the Guideline. The reserve calculated using projections is based on a Conditional Tail Expectation measure of the results for each scenario.

Conditional Tail Expectation (CTE) is a statistical risk measure that provides enhanced information about the tail of a distribution above that provided by the traditional use of percentiles. Instead of only identifying a value at a particular percentile and thus ignoring the possibility of extremely large values in the tail, CTE recognizes a portion of the tail by providing the average over all values in the tail beyond the CTE percentile. Thus where the tail of the distribution of losses approximates that of a standard normal distribution, CTE (70) will approximate the 88th percentile; where the tail is “fatter” than that of a standard normal distribution, CTE (70) will exceed the 88th percentile; and where the tail is not as “fat” as a standard normal distribution, CTE (70) will be lower than the 88th percentile. Therefore, for distributions with “fat tails” from low probability, high impact events, such as those covered by the Guideline, the use of CTE will provide a more revealing measure than use of a single percentile requirement.

For certain products (e.g., variable annuities with Guaranteed Minimum Death Benefits only), a company can use an Alternative Methodology in place of the modeling approach outlined above to determine the Conditional Tail Expectation Amount.

The projection methodology used to calculate the Conditional Tail Expectation Amount, as well as the approach used to develop the Alternative Methodology, is based on the following set of principles. These principles should be followed when applying the methodology in the Guideline and analyzing the resulting reserves.

**Principle 1.** The objective of the approach used to determine the Conditional Tail Expectation Amount is to quantify the amount of statutory reserves needed by the company to be able to meet contractual obligations in light of the risks to which the company is exposed.

**Principle 2.** The calculation of the Conditional Tail Expectation Amount is based on the results derived from an analysis of asset and liability cash flows produced by the application of a stochastic cash flow model to equity return and interest rate scenarios. For each scenario the greatest present value of accumulated surplus deficiency is calculated. The analysis reflects Prudent Estimate (see the definition of Prudent Estimate in Section III) assumptions for deterministic variables and is performed in aggregate (subject to limitations related to contractual provisions) to allow the natural offset of risks within a given scenario. The methodology utilizes a projected total statutory balance sheet approach by including all projected income, benefit and expense items related to the business in the model and sets the Conditional Tail Expectation Amount at a degree of confidence using the conditional tail expectation measure applied to the set of scenario specific greatest present values of accumulated statutory deficiencies that is deemed to be reasonably conservative over the span of economic cycles.

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1 Note the following when considering these principles:
   a. The principles should be considered in their entirety.
   b. The Guideline requires companies to meet these principles with respect to only those contracts that fall within the scope of the Guideline and are in force as of the valuation date to which the requirements are applied.

2 Examples where full aggregation between contracts may not be possible include experience rated group contracts and the operation of reinsurance treaties.
Principle 3. The implementation of a model involves decisions about the experience assumptions and the modeling techniques to be used in measuring the risks to which the company is exposed. Generally, assumptions are to be based on the conservative end of the actuary’s confidence interval. The choice of a conservative estimate for each assumption may result in a distorted measure of the total risk. Conceptually, the choice of assumptions and the modeling decisions should be made so that the final result approximates what would be obtained for the Conditional Tail Expectation Amount at the required CTE level if it were possible to calculate results over the joint distribution of all future outcomes. In applying this concept to the actual calculation of the Conditional Tail Expectation Amount, the actuary should be guided by evolving practice and expanding knowledge base in the measurement and management of risk.

Principle 4. While a stochastic cash flow model attempts to include all real world risks relevant to the objective of the stochastic cash flow model and relationships among the risks, it will still contain limitations because it is only a model. The calculation of the Conditional Tail Expectation Amount is based on the results derived from the application of the stochastic cash flow model to scenarios while the actual statutory reserve needs of the company arise from the risks to which the company is (or will be) exposed in reality. Any disconnect between the model and reality should be reflected in setting Prudent Estimate assumptions to the extent not addressed by other means.

Principle 5. Neither a cash flow scenario model, nor a method based on factors calibrated to the results of a cash flow scenario model, can completely quantify a company’s exposure to risk. A model attempts to represent reality, but will always remain an approximation thereto and hence uncertainty in future experience is an important consideration when determining the Conditional Tail Expectation Amount. Therefore, the use of assumptions, methods, models, risk management strategies (e.g., hedging), derivative instruments, structured investments or any other risk transfer arrangements (such as reinsurance) that serve solely to reduce the calculated Conditional Tail Expectation Amount without also reducing risk on scenarios similar to those used in the actual cash flow modeling are inconsistent with these principles. The use of assumptions and risk management strategies should be appropriate to the business and not merely constructed to exploit ‘foreknowledge’ of the components of the required methodology.

The methodology prescribed in the Guideline is applied to a company’s entire portfolio of variable annuities (whether or not they contain guaranteed benefits), as well as other affected products that contain guaranteed benefits. Current guaranteed benefits include Guaranteed Minimum Death Benefits, Guaranteed Minimum Accumulation Benefits, Guaranteed Minimum Income Benefits, Guaranteed Minimum Withdrawal Benefits, Guaranteed Lifetime Withdrawal Benefits, and Guaranteed Payout Annuity Floors. It is also expected that the methodology in the Guideline will be applied to future variations on these designs and to new guarantee designs.

Since statutory reporting requires companies to report reserves prior to reinsurance, the Guideline clarifies standards for adjusting the various components of the reserve so that the reserve may be reported both prior to and net of reinsurance.

The Guideline also requires an allocation of the total reported reserve between the General and Separate Accounts and prescribes a method for doing this allocation.

3 The intent of Principle 3 is to describe the conceptual framework for setting assumptions. Appendix 9 provides the requirements and guidance for setting contractholder behavior and includes alternatives to this framework if the actuary is unable to fully apply this principle.
Actuarial certification of the work done to calculate reserves is required by the Guideline. A qualified actuary (referred to throughout the Guideline as “the actuary”) shall certify that the work has been done in a way that meets all applicable Actuarial Standards of Practice.

For more details on the development of these requirements, including the development of the calibration criteria, see the American Academy of Actuaries recommendation on C-3 Phase II risk-based capital.

This Guideline and its Appendices require the actuary to make various determinations, verifications and certifications. The company shall provide the actuary with the necessary information sufficient to permit the actuary to fulfill the responsibilities set forth in this Guideline and its Appendices and responsibilities arising from applicable Actuarial Standards of Practice, including ASOP No. 23, *Data Quality*.

The risks reflected in the calculation of reserves under this Guideline arise from actual or potential events or activities which are both:

a) Directly related to the contracts falling under the scope of this Guideline or their supporting assets; and

b) Capable of materially affecting the reserve.

Categories and examples of risks reflected in the reserve calculations include but are not necessarily limited to:

a) Asset Risks
   (i) Separate Account fund performance;
   (ii) Credit risks (e.g., default or rating downgrades);
   (iii) Commercial mortgage loan rollover rates (roll-over of bullet loans);
   (iv) Uncertainty in the timing or duration of asset cash flows (e.g., shortening (prepayment risk) and lengthening (extension risk));
   (v) Performance of equities, real estate, and Schedule BA assets;
   (vi) Call risk on callable assets;
   (vii) Risk associated with hedge instrument (includes basis, gap, price, parameter estimation risks, and variation in assumptions); and
   (viii) Currency risk.

b) Liability Risks
   (i) Reinsurer default, impairment or rating downgrade known to have occurred before or on the valuation date;
   (ii) Mortality/longevity, persistency/lapse, partial withdrawal and premium payment risks;
   (iii) Utilization risk associated with guaranteed living benefits;
   (iv) Anticipated mortality trends based on observed patterns of mortality improvement or deterioration, where permitted;
   (v) Annuitzation risks; and
   (vi) Additional premium dump-ins (high interest rate guarantees in low interest rate environments);

c) Combination Risks
   (i) Risks modeled in the company’s risk assessment processes that are related to the contracts, as described above;
   (ii) Disintermediation risk (including such risk related to payment of surrender or partial withdrawal benefits); and
   (iii) Risks associated with Revenue Sharing Income.
The risks not necessarily reflected in the calculation of reserves under this Guideline are:

a) Those not reflected in the determination of Risk-Based Capital; and
b) Those reflected in the determination of Risk-Based Capital but arising from obligations of the company not directly related to the contracts falling under the scope of this Guideline, or their supporting assets, as described above.

Categories and examples of risks not reflected in the reserve calculations include but are not necessarily limited to:

a) Asset Risks
   Liquidity risks associated with a “run on the bank.”

b) Liability Risks
   (i) Reinsurer default, impairment or rating downgrade occurring after the valuation date;
   (ii) Catastrophic events (e.g., epidemics or terrorist events);
   (iii) Major breakthroughs in life extension technology that have not yet fundamentally altered recently observed mortality experience; and
   (iv) Significant future reserve increases as an unfavorable scenario is realized.

c) General Business Risks
   (i) Deterioration of reputation;
   (ii) Future changes in anticipated experience (reparameterization in the case of stochastic processes) which would be triggered if and when adverse modeled outcomes were to actually occur;
   (iii) Poor management performance;
   (iv) The expense risks associated with fluctuating amounts of new business;
   (v) Risks associated with future economic viability of the company;
   (vi) Moral hazards; and
   (vii) Fraud and theft.

Section II) Scope

A) The Guideline applies to contracts, whether directly written or assumed through reinsurance, falling into any of the following categories:

1) Variable deferred annuity contracts subject to the Commissioner’s Annuity Reserve Valuation Method (CARVM), whether or not such contracts contain Guaranteed Minimum Death Benefits (GMDBs), or Variable Annuity Guaranteed Living Benefits (VAGLBs);

2) Variable immediate annuity contracts, whether or not such contracts contain GMDBs or VAGLBs;

3) Group annuity contracts that are not subject to CARVM, but contain guarantees similar in nature to GMDBs, VAGLBs, or any combination thereof; and

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4 The term “similar in nature,” as used in sections II)(A)3) and II)(A)4) is intended to capture both current products and benefits as well as product and benefit designs that may emerge in the future. Examples of the currently known designs are listed in footnote #5 below. Any product or benefit design that does not clearly fit the Scope should be evaluated on a case-by-case basis taking into consideration factors that include, but are not limited to, the nature of the guarantees, the definitions of GMDB and VAGLB in sections III)(A)1) and III)(A)2) and whether the contractual amounts paid in the absence of the guarantee are based on the investment performance of a market-value fund or market-value index (whether or not part of the company’s separate account).
4) All other products that contain guarantees similar in nature to GMDBs or VAGLBs, even if the insurer does not offer the mutual funds or variable funds to which these guarantees relate, where there is no other explicit reserve requirement.\(^5\)

If such a benefit is offered as part of a contract that has an explicit reserve requirement and that benefit does not currently have an explicit reserve requirement:

a) The Guideline shall be applied to the benefit on a standalone basis (i.e., for purposes of the reserve calculation, the benefit shall be treated as a separate contract);

b) The reserve for the underlying contract is determined according to the explicit reserve requirement; and

c) The reserve held for the contract shall be the sum of a) and b).

B) The Guideline does not apply to contracts falling under the scope of the NAIC Model Modified Guaranteed Annuity Regulation (MGAs); however, it does apply to contracts listed above that include one or more subaccounts containing features similar in nature to those contained in MGAs (e.g., market value adjustments).

C) Separate account products that guarantee an index and do not offer GMDBs or VAGLBs are excluded from the scope of the Guideline.

Section III) Definitions

A) Definitions of Benefit Guarantees

1) Guaranteed Minimum Death Benefit (GMDB). A GMDB is a guaranteed benefit providing, or resulting in the provision that, an amount payable on the death of a contractholder, annuitant, participant, or insured will be increased and/or will be at least a minimum amount. Only such guarantees having the potential to produce a contractual total amount payable on death that exceeds the account value, or in the case of an annuity providing income payments, an amount payable on death other than continuation of any guaranteed income payments, are included in this definition. GMDBs that are based on a portion of the excess of the account value over the net of premiums paid less partial withdrawals made (e.g., an Earnings Enhanced Death Benefit) are also included in this definition.

2) Variable Annuity Guaranteed Living Benefit (VAGLB). A VAGLB is a guaranteed benefit providing, or resulting in the provision that, one or more guaranteed benefit amounts payable or accruing to a living contractholder or living annuitant, under contractually specified conditions (e.g., at the end of a specified waiting period, upon annuitization, or upon withdrawal of premium over a period of time), will increase contractual benefits should the contract value referenced by the guarantee (e.g., account value) fall below a given level or fail to achieve certain performance levels. Only such guarantees having the potential to provide benefits with a present value as of the benefit commencement date that exceeds the contract value referenced by the guarantee are included in this definition. Payout annuities without minimum payout or performance guarantees are neither considered to contain nor to be VAGLBs.

\(^5\) For example, a group life contract that wraps a GMDB around a mutual fund would generally fall under the scope of the Guideline since there is not an explicit reserve requirement for this type of group life contract. However, for an individual variable life contract with a GMDB and a benefit similar in nature to a VAGLB, the Guideline would generally apply only to the VAGLB-type benefit, since there is an explicit reserve requirement that applies to the variable life contract and the GMDB.
3) **Guaranteed Minimum Income Benefit (GMIB).** A GMIB is a VAGLB design for which the benefit is contingent on annuitization of a variable deferred annuity or similar contract. The benefit is typically expressed as a contractholder option, on one or more option dates, to have a minimum amount applied to provide periodic income using a specified purchase basis.

4) **Guaranteed Payout Annuity Floor (GPAF).** A GPAF is a VAGLB design guaranteeing that one or more of the periodic payments under a variable immediate annuity will not be less than a minimum amount.

**B) Definitions of Reserve Methodology Terminology**

1) **Scenario.** A scenario consists of a set of asset growth rates and investment returns from which assets and liabilities supporting a set of contracts may be determined for each year of a projection.

2) **Cash Surrender Value.** For purposes of the Guideline, the Cash Surrender Value for a contract is the amount available to the contractholder upon surrender of the contract. Generally, it is equal to the account value less any applicable surrender charges, where the surrender charge reflects the availability of any free partial surrender options. For contracts where all or a portion of the amount available to the contractholder upon surrender is subject to a market value adjustment, however, the Cash Surrender Value shall reflect the market value adjustment consistent with the required treatment of the underlying assets. That is, the Cash Surrender Value shall reflect any market value adjustments where the underlying assets are reported at market value, but shall not reflect any market value adjustments where the underlying assets are reported at book value.

3) **Scenario Greatest Present Value.** For a given scenario, the Scenario Greatest Present Value is the sum of:
   a) The greatest of the present values, as of the projection start date, of the projected Accumulated Deficiencies for the scenario; and
   b) The Starting Asset Amount, as defined below.

4) **Conditional Tail Expectation Amount.** The Conditional Tail Expectation Amount is equal to the numerical average of the 30 percent largest values of the Scenario Greatest Present Values.

5) **Working Reserve.** The Working Reserve is the assumed reserve used in the projections of Accumulated Deficiencies supporting the calculation of the Scenario Greatest Present Values. At any point in the projections, including at the start of the projection, the Working Reserve shall equal the projected Cash Surrender Value.

For a variable payout annuity without a Cash Surrender Value, the Working Reserve shall equal the present value, at the valuation interest rate and the valuation mortality table specified for such a product by the Standard Valuation Law of future income payments projected using a return based on the valuation interest rate less appropriate asset based charges. For annuitizations that occur during the projection, the valuation interest rate as of the current valuation date may be used in determining the Working Reserve. Alternatively, if an integrated model of equity returns and interest rates is used, a future estimate of valuation interest rates may be incorporated into the Working Reserve.
For contracts not covered above, the actuary shall determine the Working Reserve in a manner that is consistent with the above requirements.

6) Accumulated Deficiency. Accumulated Deficiency is an amount measured as of the end of a projection year and equals the projected Working Reserve less the amount of projected assets, both as of the end of the projection year. Accumulated Deficiencies may be positive or negative.⁶

7) Starting Asset Amount. The Starting Asset Amount equals the value of the assets at the start of the projection, as defined in section A1.4)(A) of Appendix 1.

8) Prudent Estimate. The deterministic assumptions to be used for projections are to be the actuary’s Prudent Estimate. This means that they are to be set at the conservative end of the actuary’s confidence interval as to the true underlying probabilities for the parameter(s) in question, based on the availability of relevant experience and its degree of credibility.

A Prudent Estimate assumption is developed by applying a margin for uncertainty to the “Anticipated Experience” assumption. The margin for uncertainty shall provide for estimation error and margins for adverse deviation. The resulting Prudent Estimate assumption shall be reasonably conservative over the span of economic cycles and over a plausible range of expected experience, in recognition of the Principles described in Section I. “Anticipated Experience” would typically be the actuary’s reasonable estimate of future experience for a risk factor given all available, relevant information pertaining to the contingencies being valued. Recognizing that assumptions are simply assertions of future unknown experience, the margin should be directly related to uncertainty in the underlying risk factor. The greater the uncertainty, the larger the margin. Each margin should serve to increase the Aggregate Reserve that would otherwise be held in its absence (i.e., using only the Anticipated Experience assumption).

For example, assumptions for circumstances that have never been observed require more margins for error than those for which abundant and relevant experience data are available.

This means that valuation assumptions not stochastically modeled are to be consistent with the stated Principles in Section I, be based on any relevant and credible experience that is available, and should be set to produce, in concert with other Prudent Estimate assumptions, a Conditional Tail Expectation Amount that is consistent with the stated CTE level.

The actuary shall follow the principles discussed in Appendices 9 and 10 in determining Prudent Estimate assumptions.

9) Gross Wealth Ratio. The Gross Wealth Ratio is the cumulative return for the indicated time period and percentile (e.g., 1.0 indicates that the index is at its original level).

10) Clearly Defined Hedging Strategy. The designation of Clearly Defined Hedging Strategy applies to strategies undertaken by a company to manage risks through the future purchase or sale of hedging instruments and the opening and closing of hedging positions. In order to qualify as a Clearly Defined Hedging Strategy, the strategy must

⁶ Note that a positive Accumulated Deficiency means that there is a cumulative loss and a negative Accumulated Deficiency means that there is a cumulative gain.
meet the principles outlined in the Background section of the Guideline (particularly Principle 5) and shall, at a minimum, identify:

a) The specific risks being hedged (e.g., delta, rho, vega, etc.),
b) The hedge objectives,
c) The risks not being hedged (e.g., variation from expected mortality, withdrawal, and other utilization or decrement rates assumed in the hedging strategy, etc.),
d) The financial instruments that will be used to hedge the risks,
e) The hedge trading rules including the permitted tolerances from hedging objectives,
f) The metric(s) for measuring hedging effectiveness,
g) The criteria that will be used to measure effectiveness,
h) The frequency of measuring hedging effectiveness,
i) The conditions under which hedging will not take place, and
j) The person or persons responsible for implementing the hedging strategy.

The hedge strategy may be dynamic, static, or a combination thereof.

It is important to note that strategies involving the offsetting of the risks associated with variable annuity guarantees with other products outside of the scope of the Guideline (e.g., equity-indexed annuities) do not currently qualify as a Clearly Defined Hedging Strategy under the Guideline.

11) **Revenue Sharing.** Revenue Sharing, for purposes of the Guideline, means any arrangement or understanding by which an entity responsible for providing investment or other types of services makes payments to the company (or to one of its affiliates). Such payments are typically in exchange for administrative services provided by the company (or its affiliate), such as marketing, distribution and recordkeeping. Only payments that are attributable to charges or fees taken from the underlying variable funds or mutual funds supporting the contracts that fall under the scope of the Guideline shall be included in the definition of Revenue Sharing.

12) **Domiciliary Commissioner.** For purposes of the Guideline, this term refers to the chief insurance regulatory official of the state of domicile of the company.

13) **Aggregate Reserve.** The minimum reserve requirement as of the valuation date for the contracts falling within the scope of the Guideline.

14) **1994 Variable Annuity MGDB Mortality Table.** This mortality table is shown in Appendix 11.

**Section IV) Definition of General Reserve Methodology**

A) **General Description.** The Aggregate Reserve for contracts falling within the scope of the Guideline shall equal the Conditional Tail Expectation Amount but not less than the Standard Scenario Amount, where the Aggregate Reserve is calculated as the Standard Scenario Amount plus the excess, if any, of the Conditional Tail Expectation Amount over the Standard Scenario Amount.

B) **Impact of Reinsurance Ceded.** Where reinsurance is ceded for all or a portion of the contracts, both components in the above general description (and thus the Aggregate Reserve) shall be determined net of any reinsurance treaties that meet the statutory requirements that would allow the treaty to be accounted for as reinsurance.
An Aggregate Reserve before reinsurance shall also be calculated if needed for regulatory reporting or other purposes, using methods described in Appendix 2.

C) The Standard Scenario Amount. The Standard Scenario Amount is the aggregate of the reserves determined by applying the Standard Scenario method to each of the contracts falling within the scope of the Guideline. The Standard Scenario method is outlined in Appendix 3.

D) The Conditional Tail Expectation Amount. The Conditional Tail Expectation Amount shall be determined based on a projection of the contracts falling within the scope of the Guideline, and the assets supporting these contracts, over a broad range of stochastically generated projection scenarios and using Prudent Estimate assumptions.

The stochastically generated projection scenarios shall meet the Scenario Calibration Criteria described in Appendix 5.

The Conditional Tail Expectation Amount may be determined in aggregate for all contracts falling within the scope of the Guideline (i.e., a single grouping). At the option of the company, it may be determined by applying the methodology outlined below to sub-groupings of contracts, in which case, the Conditional Tail Expectation Amount shall equal the sum of the amounts computed for each such sub-grouping.

The Conditional Tail Expectation Amount shall be determined using the following steps:

1) For each scenario, projected aggregate Accumulated Deficiencies are determined at the start of the projection (i.e., “time 0”) and at the end of each projection year as the sum of the Accumulated Deficiencies for each contract grouping.

2) The Scenario Greatest Present Value is determined for each scenario based on the sum of the aggregate Accumulated Deficiencies and aggregate Starting Asset Amounts for the contracts for which the Aggregate Reserve is being computed.

3) The Scenario Greatest Present Values for all scenarios are then ranked from smallest to largest and the Conditional Tail Expectation Amount is the average of the largest 30 percent of these ranked values.

The projections shall be performed in accordance with Appendix 1. The actuary shall document the assumptions and procedures used for the projections and summarize the results obtained as described in Appendix 2 and Appendix 8.

E) Alternative Methodology. For variable deferred annuity contracts that contain either no guaranteed benefits or only GMDBs (i.e., no VAGLBs), the Conditional Tail Expectation Amount may be determined using the Alternative Methodology described in Appendix 4 rather than using the approach described in subsection D) above. However, in the event the approach described in subsection D) has been used in prior valuations the Alternative Methodology may not be used without approval from the Domiciliary Commissioner.

The Conditional Tail Expectation Amount for the group of contracts to which the Alternative Methodology is applied shall not be less than the aggregate Cash Surrender Value of those contracts.

7 The Scenario Greatest Present Value is therefore based on the greatest projected Accumulated Deficiency, in aggregate, for all contracts for which the Aggregate Reserve is computed hereunder, rather than based on the sum of the greatest projected Accumulated Deficiency for each grouping of contracts.
The actuary shall document the assumptions and procedures used for the Alternative Methodology and summarize the results obtained as described in Appendix 2 and Appendix 8.

F) **Allocation of Results to Contracts.** The Aggregate Reserve shall be allocated to the contracts falling within the scope of the Guideline using the method outlined in Appendix 6.

G) **Reserve as of January 1, 2009.** The reserve as of January 1, 2009 shall be the sum of the reserves from the asset adequacy analysis requirements in Actuarial Guideline XXXIV and Actuarial Guideline XXXIX.

**Section V) Effective Date**

The Guideline affects all contracts issued on or after January 1, 1981, effective December 31, 2009. Where the application of the Guideline produces higher reserves than the company had otherwise established by their previously used interpretation, such company may request a grade-in period, not to exceed three (3) years, from the Domiciliary Commissioner upon satisfactory demonstration of the previous interpretation and that such delay of implementation will not cause a hazardous financial condition or potential harm to its policyholders. The grading shall be done only on the reserves on the contracts in-force as of December 31, 2009. The reserves under the old basis and new basis shall be compared each year - 2/3 of the difference shall be subtracted from the reserve under the new basis in 2009 and 1/3 of the difference shall be subtracted from the reserve under the new basis in 2010.
APPENDIX 1 - Determination of Conditional Tail Expectation Amount Based on Projections

A1.1) Projection of Accumulated Deficiencies

A) General Description of Projection. The projection of Accumulated Deficiencies shall be made ignoring Federal Income Tax and reflect the dynamics of the expected cash flows for the entire group of contracts, reflecting all product features, including the guarantees provided under the contracts. Insurance company expenses (including overhead and investment expense), fund expenses, contractual fees and charges, revenue sharing income received by the company (net of applicable expenses) and cash flows associated with any reinsurance or hedging instruments are to be reflected on a basis consistent with the requirements herein. Cash flows from any fixed account options shall also be included. Any market value adjustment assessed on projected withdrawals or surrenders shall also be included (whether or not the Cash Surrender Value reflects market value adjustments). Throughout the projection, where estimates are used, such estimates shall be on a Prudent Estimate basis.

Federal Income Tax shall not be included in the projection of Accumulated Deficiencies.

B) Grouping of Variable Funds and Subaccounts. The portion of the Starting Asset Amount held in the Separate Account represented by the variable funds and the corresponding account values may be grouped for modeling using an approach that recognizes the investment guidelines and objectives of the funds. In assigning each variable fund and the variable subaccounts to a grouping for projection purposes, the fundamental characteristics of the fund shall be reflected and the parameters shall have the appropriate relationship to the required calibration points of the S&P 500. The grouping shall reflect characteristics of the efficient frontier (i.e., returns generally cannot be increased without assuming additional risk).

An appropriate proxy for each variable subaccount shall be designed in order to develop the investment return paths. The development of the scenarios for the proxy funds is a fundamental step in the modeling and can have a significant impact on results. As such, the actuary must map each variable account to an appropriately crafted proxy fund normally expressed as a linear combination of recognized market indices (or sub-indices).

C) Grouping of Contracts. Projections may be performed for each contract in force on the date of valuation or by grouping contracts into representative cells of model plans using all characteristics and criteria having a material impact on the size of the reserve. Grouping shall be the responsibility of the actuary but may not be done in a manner that intentionally understates the resulting reserve.

D) Modeling of Hedges. The appropriate costs and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline shall be included in the projections. If the company is following a Clearly Defined Hedging Strategy and the hedging strategy meets the requirements of Appendix 7, the projections shall take into account the appropriate costs and benefits of hedge positions expected to be held in the future through the execution of that strategy.

To the degree either the currently held hedge positions or the hedge positions expected to be held in the future introduce basis, gap, price, or assumption risk, a suitable reduction for effectiveness of hedges shall be made. The actuary is responsible for verifying compliance with a Clearly Defined Hedging Strategy and the requirements in Appendix 7 for all hedge instruments included in the projections.
While hedging strategies may change over time, any change in hedging strategy shall be documented and include an effective date of the change in strategy.

The use of products not falling under the scope of the Guideline (e.g., equity-indexed annuities) as a hedge shall not be recognized in the determination of Accumulated Deficiencies.

These requirements do not supersede any statutes, laws, or regulations of any state or jurisdiction related to the use of derivative instruments for hedging purposes and should not be used in determining whether a company is permitted to use such instruments in any state or jurisdiction.

Upon request of the company’s domiciliary commissioner and for information purposes to show the effect of including future hedge positions in the projections, the company shall show the results of performing an additional set of projections reflecting only the hedges currently held by the company in support of the contracts falling under the scope of the Guideline. Because this additional set of projections excludes some or all of the derivative instruments, the investment strategy used may not be the same as that used in the determination of the Conditional Tail Expectation Amount.

E) Revenue Sharing.

1) Projections of Accumulated Deficiencies may include income from projected future Revenue Sharing, as defined in Section III) net of applicable projected expenses (“Net Revenue Sharing Income”) if the following requirements are met:
   a) The Net Revenue Sharing Income is received by the company,
   b) Signed contractual agreement or agreements are in place as of the valuation date and support the current payment of the Net Revenue Sharing Income; and
   c) The Net Revenue Sharing Income is not already accounted for directly or indirectly as a company asset.

2) The amount of Net Revenue Sharing Income to be used shall reflect the actuary’s assessment of factors that include but are not limited to the following (not all of these factors will necessarily be present in all situations):
   a) The terms and limitations of the agreement(s), including anticipated revenue, associated expenses and any contingent payments incurred or made by either the company or the entity providing the Net Revenue Sharing as part of the agreement(s);
   b) The relationship between the company and the entity providing the Net Revenue Sharing Income that might affect the likelihood of payment and the level of expenses;
   c) The benefits and risks to both the company and the entity paying the Net Revenue Sharing Income of continuing the arrangement.

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8 For purposes of this section, Net Revenue Sharing Income is considered to be received by the company if it is paid directly to the company through a contractual agreement with either the entity providing the Net Revenue Sharing Income or an affiliated company that receives the Net Revenue Sharing Income. Net Revenue Sharing Income would also be considered to be received, if it is paid to a subsidiary that is owned by the company and if 100% of the statutory income from that subsidiary is reported as statutory income of the company. In this case the actuary needs to assess the likelihood that future Net Revenue Sharing Income is reduced due to the reported statutory income of the subsidiary being less than future Net Revenue Sharing Income received.

9 As in other sections of the Guideline, the term “the company” is used exclusively as a reference to the insurance company writing the business falling under the scope of the Guideline. The term “entity providing the Net Revenue Sharing Income” is self-explanatory and is used consistently in this subsection.
d) The likelihood that the company will collect the Net Revenue Sharing Income during the term(s) of the agreement(s) and the likelihood of continuing to receive future revenue after the agreement(s) has ended;

e) The ability of the company to replace the services provided to it by the entity providing the Net Revenue Sharing Income or to provide the services itself, along with the likelihood that the replaced or provided services will cost more to provide; and

f) The ability of the entity providing the Net Revenue Sharing Income to replace the services provided to it by the company or to provide the services itself, along with the likelihood that the replaced or provided services will cost more to provide.

3) The amount of projected Net Revenue Sharing Income shall also reflect a margin (which decreases the assumed Net Revenue Sharing Income) directly related to the uncertainty of the revenue. The greater the uncertainty, the larger the margin. Such uncertainty is driven by many factors including the potential for changes in the securities laws and regulations, mutual fund board responsibilities and actions, and industry trends. Since it is prudent to assume that uncertainty increases over time, a larger margin shall be applied as time that has elapsed in the projection increases.

4) All expenses required or assumed to be incurred by the company in conjunction with the arrangement providing the Net Revenue Sharing Income, as well as any expenses assumed to be incurred by the company in conjunction with the assumed replacement of the services provided to it (as discussed in subsection 2)e) above) shall be included in the projections as a company expense under the requirements of section A1.1)A). In addition, expenses incurred by either the entity providing the Net Revenue Sharing Income or an affiliate of the company shall be included in the applicable expenses discussed in section A1.1)A) and A1.1)E)1) that reduce the Net Revenue Sharing Income.

5) The actuary is responsible for reviewing the revenue sharing agreements, verifying compliance with these requirements, and documenting the rationale for any source of Net Revenue Sharing Income used in the projections.

6) The amount of Net Revenue Sharing Income assumed in a given scenario shall not exceed the sum of a) and b), where:

   a) Is the contractually guaranteed Net Revenue Sharing Income projected under the scenario, and

   b) Is the actuary’s estimate of non-contractually guaranteed Net Revenue Sharing Income before reflecting any margins for uncertainty multiplied by the following factors:

   (i) 1.0 in the first projection year;
   (ii) 0.9 in the second projection year;
   (iii) 0.8 in the third projection year;
   (iv) 0.7 in the fourth projection year;
   (v) 0.6 in the fifth projection year;
   (vi) 0.5 in the sixth and all subsequent projection years. The resulting amount of non-contractually guaranteed Net Revenue Sharing Income after application of this factor shall not exceed 0.25% per year on separate account assets in the sixth and all subsequent projection years.

F) Length of Projections. Projections of Accumulated Deficiencies shall be run for as many future years as needed so that no materially greater reserve value would result from longer projection periods.
G) **AVR/IMR.** The AVR and the IMR shall be handled consistently with the treatment in the company’s cash flow testing.

A1.2) **Determination of Scenario Greatest Present Values**

A) **Scenario Greatest Present Values.** For a given scenario, the Scenario Greatest Present Value is the sum of:

1) The greatest present value, as of the projection start date, of the projected Accumulated Deficiencies defined in Section III)B)6); and

2) The Starting Asset Amount.

B) **Discount Rates.** In determining the Scenario Greatest Present Values, Accumulated Deficiencies shall be discounted using the same interest rates at which positive cash flows are invested, as determined in section A1.4)D). Such interest rates shall be reduced to reflect expected credit losses. Note that the interest rates used do not include a reduction for Federal Income Taxes.

A1.3) **Projection Scenarios**

A) **Minimum Required Scenarios.** The number of scenarios for which projected greatest present values of Accumulated Deficiencies shall be computed shall be the responsibility of the actuary and shall be considered to be sufficient if any resulting understatement in total reserves, as compared with that resulting from running additional scenarios, is not material.

B) **Scenario Calibration Criteria.** Returns for the groupings of variable funds shall be determined on a stochastic basis such that the resulting distribution of the Gross Wealth Ratios of the scenarios meets the Scenario Calibration Criteria specified in Appendix 5.

A1.4) **Projection Assets**

A) **Starting Asset Amount.** For the projections of Accumulated Deficiencies, the value of assets at the start of the projection shall be set equal to the approximate value of statutory reserves at the start of the projection. Assets shall be valued consistently with their annual statement values. The amount of such asset values shall equal the sum of the following items, all as of the start of the projection:

1) All of the Separate Account assets supporting the contracts;

2) An amount of assets held in the General Account equal to the approximate value of statutory reserves as of the start of the projections less the amount in 1), above.

In many instances the initial General Account assets may be negative, resulting in a projected interest expense. General Account assets chosen for use as described above shall be selected on a consistent basis from one reserve valuation hereunder to the next.

Any hedge assets meeting the requirements described in section A1.1)D) shall be reflected in the projections and included with other General Account assets under item 2) above. To the extent the sum of the value of such hedge assets and the value of assets in item 1) above is greater than the approximate value of statutory reserves as of the start of the projections, then item 2) above may include enough negative General Account assets or cash such that the sum of items 1) and 2)
above equals the approximate value of statutory reserves as of the start of the projections.10

The actuary shall document which assets were used as of the start of the projection, the approach used to determine which assets were chosen and shall verify that the value of the assets equals the approximate value of statutory reserves at the start of the projection.

B) Valuation of Projected Assets. For purposes of determining the projected Accumulated Deficiencies, the value of projected assets shall be determined in a manner consistent with their value at the start of the projection. For assets assumed to be purchased during a projection, the value shall be determined in a manner consistent with the value of assets at the start of the projection that have similar investment characteristics.

C) Separate Account Assets. For purposes of determining the Starting Asset Amounts in subsection A) and the valuation of projected assets in subsection B), assets held in a Separate Account shall be summarized into asset categories determined by the actuary as discussed in section A1.1)B).

D) General Account Assets. General Account assets shall be projected, net of projected defaults, using assumed investment returns consistent with their book value and expected to be realized in future periods as of the date of valuation. Initial assets that mature during the projection and positive cash flows projected for future periods shall be invested at interest rates, which, at the option of the actuary, are one of the following:

1) The forward interest rates implied by the swap curve11 in effect as of the valuation date,

2) The 200 interest rate scenarios available as prescribed for Phase I, C-3 Risk Based Capital calculation, coupled with the Separate Account return scenarios by mating them up with the first 200 such scenarios and repeating this process until all Separate Account return scenarios have been mated with a Phase I scenario, or

3) Interest rates developed for this purpose from a stochastic model that integrates the development of interest rates and the Separate Account returns.

When the option described in 1) above (the forward interest rates implied by the swap curve) is used, an amount shall be subtracted from the interest rates to reflect the current market expectations about future interest rates using the process described in section A1.5)A).

The actuary may switch from 1) to 2), from 1) to 3) or from 2) to 3) from one valuation date to the next, but may not switch in the other direction without approval from the Domiciliary Commissioner.

A1.5) Projection of Annuitzation Benefits (including GMIBs)

A) Assumed Annuitzation Purchase Rates at Election. For purposes of projecting annuity benefits (including annuitizations stemming from the election of a GMIB), the projected annuity purchase rates shall be determined assuming that market interest rates available at the time of election are the interest rates used to project General Account Assets, as determined in A1.4)D). However, where the interest rates used to project General Account Assets are based upon the forward interest rates implied by the swap curve in effect as of the valuation date (i.e.,

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10 Further elaboration on potential practices with regard to this issue may be included in a practice note.
11 The swap curve is based on the Federal Reserve H.15 interest swap rates. The rates are for a Fixed Rate Payer in return for receiving three month LIBOR. One place where these rates can be found is http://www.federalreserve.gov/releases/h15/default.htm.
the option described in section A1.4)D)1) is used, herein referred to as a point estimate), the
margin between the cost to purchase an annuity using the guaranteed purchase basis and the cost
using the interest rates prevailing at the time of annuitization shall be adjusted as discussed
below.

If a point estimate is being used, it is important that the margin assumed reflects the current
market expectations about future interest rates at the time of annuitization, as described more
fully below, and a downward adjustment to the interest rate assumed in the purchase rate basis.
The latter adjustment is necessary since a greater proportion of contractholders will select an
annuitization benefit when it is worth more than the cash surrender value then when it is not. As a
practical matter, this effect can be approximated by using an interest rate assumption in the
purchase rate basis that is 0.30 percent below that implied by the forward swap curve, as
described below.

To calculate market expectations of future interest rates, the par or current coupon swap curve is
used (documented daily in Federal Reserve H.15 with some interpolation needed). Deriving the
expected rate curve from this swap curve at a future date involves the following steps:

1) Calculate the implied zero-coupon rates. This is a well documented “bootstrap” process.
For this process we use the equation $100 = C^n \times (v + v^2 + \ldots + v^n) + 100v^n$ where the “$v^{\text{th}}$”
terms are used to stand for the discount factors applicable to cash flows 1, 2,…, n years
hence and $C^n$ is the n-year swap rate. Each of these discount factors are based on the
forward curve and therefore are based on different rates, however (i.e. “$v^2$” does not equal
$v$ times $v$). Given the one year swap rate, one can solve for $v$. Given $v$ and the two year
swap rate one can then back into $v^2$, and so on.

2) Convert the zero coupon rates to one year forward rates by calculating the discount factor
needed to get from $v^{a-1}$ to $v^a$.

3) Develop the expected rate curve.

This recognizes that, for example, the five-year forward one-year rate is not the rate the
market expects on one year instruments five years from now. The reason is that as the
bond gets shorter the “risk premium” in the rate diminishes. This is sometimes
characterized as “rolling down” the yield curve. Table A shows the historic average risk
premium at various durations. From this table, one can see that to get the rate the market
expects a 1 year swap to have five years from now; one must subtract the risk premium
associated with six year rates (.95%) and add back that associated with 1 year rates
(.50%). This results in a net reduction of .45%.

<table>
<thead>
<tr>
<th>Duration</th>
<th>Risk Premium</th>
<th>Duration</th>
<th>Risk Premium</th>
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<tbody>
<tr>
<td>1</td>
<td>0.500%</td>
<td>6</td>
<td>0.950%</td>
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<tr>
<td>2</td>
<td>0.750%</td>
<td>7</td>
<td>1.000%</td>
</tr>
<tr>
<td>3</td>
<td>0.750%</td>
<td>8</td>
<td>1.100%</td>
</tr>
<tr>
<td>4</td>
<td>0.850%</td>
<td>9+</td>
<td>1.150%</td>
</tr>
<tr>
<td>5</td>
<td>0.900%</td>
<td></td>
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</tbody>
</table>

Table A: Risk Premium by Duration

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The Exhibit below combines the three steps. Columns A through D convert the swap curve to the implied forward rate for each future payment date. Columns E through H remove the current risk premium, add the risk premium t years in the future (the Exhibit shows the rate curve five years in the future), and uses that to get the discount factors to apply to the 1 year, 2 year,…5 year cash flows 5 years from now.

### Exhibit: Derivation of discount rates expected in the future

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Projection Years</td>
<td>Swap Curve Rate</td>
<td>PV of Zero Coupon</td>
<td>Forward 1 Year Rate</td>
<td>Risk Premium</td>
<td>Risk Premium 5 Years Out</td>
<td>Expected Forward Rate In Five Years</td>
<td>PV of Zero Coupon In 5 Years</td>
</tr>
<tr>
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<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
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<tr>
<td>1</td>
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<td>0.97494</td>
<td>2.5700%</td>
<td>0.50000%</td>
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<td>3.5879%</td>
<td>0.75000%</td>
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<td>4.2251%</td>
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<td>0.86231</td>
<td>4.7208%</td>
<td>0.85000%</td>
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<tr>
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<td>1.10000%</td>
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<td>0.77024</td>
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</table>

Cell formulas for Projection Year 10:

- \( \text{E14} = \frac{(1-B13* \text{SUM(SC4:C12))}}{(1+B13)} \)
- \( \text{C10} = \frac{\text{C12}}{\text{C13}} \)
- \( \text{E13} = \frac{\text{D13} - \text{E13} + \text{F13}}{1+G13} \)

Where interest rates are projected stochastically using an integrated model, although one would “expect” the interest rate n years hence to be that implied for an appropriate duration asset by the forward swap curve as described above, there is a steadily widening confidence interval about that point estimate with increasing time until the annuitization date. The “expected margin” in the purchase rate is less than that produced by the point estimate based on the expected rate, since a greater proportion of contractholders will have an annuitization benefit whose worth is in excess of cash surrender value when margins are low than when margins are high. As a practical matter, this effect can be approximated by using a purchase rate margin based on an earnings rate .30 percent below that implied by the forward swap curve. If a stochastic model of interest rates is used instead of a point estimate then no such adjustment is needed.

### B) Projected Election of Guaranteed Minimum Income Benefit and other Annuitization Options

For contracts projected to elect annuitization options (including annuitizations stemming from the election of a GMIB), the projections may assume one of the following at the actuary’s option:
Appendix C

1) The contract is treated as if surrendered at an amount equal to the statutory reserve that would be required at such time for the payout annuity benefits, or

2) The contract is assumed to stay inforce, the projected periodic payments are paid, and the Working Reserve is equal to one of the following:
   a) The statutory reserve required for the payout annuity, if it is a fixed payout annuity, or
   b) If it is a variable payout annuity, the Working Reserve for a variable payout annuity as defined in Section III)B)5).

If the projected payout annuity is a variable payout annuity containing a floor guarantee (such as a GPAF) under a specified contractual option, only option 2) above shall be used.

Where mortality improvement is used to project future annuitization purchase rates, as discussed in A) above, mortality improvement shall also be reflected on a consistent basis in either the determination of the reserve in 1) above or the projection of the periodic payments in 2) above.

A1.6) Relationship to Risk Based Capital Requirements

A) The Guideline anticipates that the projections described herein may be used for the determination of Risk Based Capital (the “RBC requirements”) for some or all of the contracts falling within the scope of the Guideline. There are several differences between the requirements of the Guideline and the RBC requirements, and among them are two major differences. First, the Conditional Tail Expectation level is different (CTE (70) for the Guideline and CTE (90) for the RBC requirements). Second, the projections described in the Guideline are performed on a basis that ignores Federal Income Tax. That is, under the Guideline, the Accumulated Deficiencies do not include projected Federal Income Tax and the interest rates used to discount the Scenario Greatest Present Value (i.e., the interest rates determined in section A1.4)D)) contain no reduction for Federal Income Tax. Under the RBC requirements, the projections do include projected Federal Income Tax and the discount interest rates used in the RBC requirement do contain a reduction for Federal Income Tax.

B) To further aid the understanding of the Guideline and any instructions relating to the RBC requirement, it is important to note the equivalence in meaning between the following terms, subject to the differences noted above:

1) The amount that is added to the Starting Asset Amount in Section III)B)6) of the Guideline is similar to the Additional Asset Requirement referenced in the RBC requirement.

2) The Conditional Tail Expectation Amount referenced in the Guideline is similar to the Total Asset Requirement referenced in the RBC requirement.

A1.7) Compliance with Actuarial Standards of Practice (ASOPs)

When determining the Conditional Tail Expectation Amount using projections, the analysis shall conform to the Actuarial Standards of Practice as promulgated from time to time by the Actuarial Standards Board.

A1.8) Compliance with Principles

When determining the Conditional Tail Expectation Amount using projections, any interpretation and application of the requirements of the Guideline shall follow the principles discussed in the Section I) Background.
APPENDIX 2 - Reinsurance and Statutory Reporting Issues

A2.1) Treatment of Reinsurance Ceded in the Aggregate Reserve

A) Aggregate Reserve Net of and Prior to Reinsurance Ceded. As noted in Section IV)B), the Aggregate Reserve is determined net of reinsurance ceded. Therefore, it is necessary to determine the components needed to determine the Aggregate Reserve (i.e., the Standard Scenario Amount, and either the Conditional Tail Expectation Amount determined using projections or the Conditional Tail Expectation Amount determined using the Alternative Methodology) on a net of reinsurance basis. In addition, as noted in Section IV)B), it may be necessary to determine the Aggregate Reserve determined on a “direct” basis, or prior to reflection of reinsurance ceded. Where this is needed, each of these components shall be determined prior to reinsurance. Sections B) through D) below discuss methods necessary to determine these components on both a “net of reinsurance” and a “prior to reinsurance” basis. Note that due allowance for reasonable approximations may be used where appropriate.

B) Conditional Tail Expectation Amount Determined using Projections. In order to determine the Aggregate Reserve net of reinsurance ceded, Accumulated Deficiencies, Scenario Greatest Present Values, and the resulting Conditional Tail Expectation Amount shall be determined reflecting the effects of reinsurance treaties that meet the statutory requirements that would allow the treaty to be accounted for as reinsurance within the projections. This involves including, where appropriate, all anticipated reinsurance premiums or other costs and all reinsurance recoveries, where both premiums and recoveries are determined by recognizing any limitations in the reinsurance treaties, such as caps on recoveries or floors on premiums.

In order to determine the Conditional Tail Expectation Amount prior to reinsurance ceded, Accumulated Deficiencies, Scenario Greatest Present Values, and the resulting Conditional Tail Expectation Amount shall be determined ignoring the effects of reinsurance within the projections. One acceptable approach involves a projection based on the same Starting Asset Amount as for the Aggregate Reserve net of reinsurance and by ignoring, where appropriate, all anticipated reinsurance premiums or other costs and all reinsurance recoveries in the projections.

C) Conditional Tail Expectation Amount Determined using the Alternative Methodology. If a company chooses to use the Alternative Methodology, as allowed in Section IV)E), it is important to note that the methodology produces reserves on a prior to reinsurance ceded basis. Therefore, where reinsurance is ceded, the Alternative Methodology must be modified to reflect the reinsurance costs and reinsurance recoveries under the reinsurance treaties in the determination of the Aggregate Reserve net of reinsurance. In addition, the Alternative Methodology, unadjusted for reinsurance, shall be applied to the contracts falling under the scope of the Guideline to determine the Aggregate Reserve prior to reinsurance.

D) Standard Scenario Amount. Where reinsurance is ceded, the Standard Scenario Amount shall be calculated as described in Appendix 3 to reflect the reinsurance costs and reinsurance recoveries under the reinsurance treaties. If it is necessary, the Standard Scenario Amount shall be calculated prior to reinsurance ceded using the methods described in Appendix 3, but ignoring the effects of the reinsurance ceded.

A2.2) Aggregate Reserve to be held in the General Account

The amount of the reserve held in the General Account shall not be less than the excess of the Aggregate Reserve over the sum of the Basic Reserve, as defined in section A3.2), attributable to the variable portion of all such contracts.
A.2.3) **Actuarial Certification and Memorandum**

A) **Actuarial Certification.** Actuarial Certification of the work done to determine the Aggregate Reserve shall be required. The actuary shall certify that the work performed has been done in a way that substantially complies with all applicable Actuarial Standards of Practice. The scope of this certification does not include an opinion on the adequacy of the Aggregate Reserve,\(^\text{12}\) the company’s surplus or the company’s future financial condition. The actuary shall also note any material change in the model or assumptions from that used previously and the estimated impact of such changes.

Appendix 8 contains more information on the contents of the required Actuarial Certification.

B) **Required Memorandum.** An actuarial memorandum shall be constructed documenting the methodology and assumptions upon which the Aggregate Reserve is determined. The memorandum shall also include sensitivity tests that the actuary feels appropriate, given the composition of the company’s block of business (i.e., identifying the key assumptions that, if changed, produce the largest changes in the Aggregate Reserve). This memorandum shall have the same confidential status as the actuarial memorandum supporting the actuarial opinion\(^\text{13}\) and shall be available to regulators upon request.

Appendix 8 contains more information on the contents of the required memorandum.

C) **Conditional Tail Expectation Amount Determined using the Alternative Methodology.** Where the Alternative Methodology is used, there is no need to discuss the underlying assumptions and model in the required memorandum. Certification that expense, revenue, fund mapping, and product parameters have been properly reflected, however, shall be required.

Appendix 8 contains more information on the contents of the required Actuarial Certification and memorandum.

D) **Material Changes.** If there is a material change in results due to a change in assumptions from the previous year, the memorandum shall include a discussion of such change in assumptions and an estimate of the impact it has on the results.

\(^{12}\) The adequacy of total company reserves, which includes the Aggregate Reserve, is addressed in the company's Actuarial Opinion as required by the NAIC Model Actuarial Opinion and Memorandum Regulation.

\(^{13}\) This is consistent with Section 3D(8) of the Standard Valuation Law, which states: “Except as provided in Paragraphs (12), (13) and (14), documents, materials or other information in the possession or control of the Department of Insurance that are a memorandum in support of the opinion, and any other material provided by the company to the commissioner in connection with the memorandum, shall be confidential by law and privileged, shall not be subject to [insert open records, freedom of information, sunshine or other appropriate phrase], shall not be subject to subpoena, and shall not be subject to discovery or admissible in evidence in any private civil action. However, the commissioner is authorized to use the documents, materials or other information in the furtherance of any regulatory or legal action brought as a part of the commissioner’s official duties.”
APPENDIX 3 - Standard Scenario Requirements

A3.1) Overview

A) Application to Determine Reserves. A Standard Scenario Reserve shall be determined for each of the contracts falling under the scope of the Guideline by applying section A3.3). This includes those contracts to which the Alternative Methodology is applied.

The Standard Scenario Reserve for a contract with guaranteed living benefits or guaranteed death benefits is based on a projection of the account value based on specified returns for supporting assets equal to the account value. An initial drop is applied to the supporting assets and account value on the valuation date. Subsequently, account values are projected at specified rates earned by the supporting assets less contract and fund charges. The assumptions for the projection of account values and margins are prescribed in section A3.3)C). For any contract with guarantees the Standard Scenario Reserve includes the greatest present value of the benefit payments in excess of account values applied over the present value of revenue produced by the margins.

B) The Standard Scenario Amount

1) The Standard Scenario Amount is defined in Section IV)C) of this Guideline as the aggregate of the reserves determined by applying the Standard Scenario Method to each of the contracts falling under the scope of the Guideline. Except as provided in subsection A3.3)B)1), the Standard Scenario Amount equals the sum over all contracts of the Standard Scenario Reserve determined for each contract as of the statement date as described in A3.1)B)2).

2) The Standard Scenario Method requires the Standard Scenario Amount to not be less than the sum over all contracts of the Standard Scenario Reserve determined for the contract as of the statement date as described in section A3.3), where the Discount Rate is equal to $DR$, which is defined as the valuation interest rate specified by the Standard Valuation Law for annuities valued on an issue year basis, using Plan Type A and a Guarantee Duration greater than 10 years but not more than 20 years. The presence of guarantees of interest on future premiums and/or cash settlement options is to be determined using the terms of the contracts.

C) Illustrative Application of the Standard Scenario to a Projection or Model Office. If the Conditional Tail Expectation Amount is determined based on a projection of an inforce prior to the statement date and/or by the use of a model office, which is a grouping of contracts into representative cells, then additional determinations of A3.1)B)2) shall be performed on the prior inforce and/or model office. The calculations are for illustrative purposes to assist in validating the reasonableness of the projection and/or the model office.

The following table identifies the illustrative additional determinations required by this section using the Discount Rate, $DR$, as defined in A3.1)B)2). The additional determinations required are based on how the Conditional Tail Expectation projection or Alternative Methodology is applied. For completeness, the table also includes the determinations required by section A3.1)B)2).

1) Run A in the table is required for all companies by section A3.1)B)2). No additional determinations are required if a company’s stochastic or alternative methodology result is calculated on individual contracts as of the statement date.

2) A company that uses a model office as of the statement date to determine its stochastic or alternative methodology result must provide an additional determination for the model office based on the Discount Rate $DR$, run B.
3) A company that uses a contract by contract listing of a prior inforce to determine its stochastic or alternative methodology with result PS and then projects requirements to the statement date with result S must provide an additional determination for the prior inforce based on the Discount Rate $DR$, run C.

4) A company that uses a model office of a prior inforce to determine its stochastic or alternative methodology requirements with result PM and then projects requirements to the statement date with result S must provide an additional determination for the prior model office based on the Discount Rate $DR$, run D.

<table>
<thead>
<tr>
<th>Standard Scenario Run</th>
<th>Guideline Variations</th>
<th>Validation Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A.</strong> Valuation on the statement date on inforce contracts with discount rate $DR$</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>B.</strong> Valuation on the statement date on the model office with discount rate $DR$</td>
<td>If not material to model office validation</td>
<td>A/B compare to 1.00</td>
</tr>
<tr>
<td><strong>C.</strong> Valuation on a prior inforce date on prior inforce contracts with discount rate $DR$</td>
<td>If not material to projection validation</td>
<td>None</td>
</tr>
<tr>
<td><strong>D.</strong> Valuation on a prior inforce date on a model office with discount rate $DR$</td>
<td>If not material to model office or projection validation.</td>
<td>(A/D – S/PM) compare to 0</td>
</tr>
</tbody>
</table>

Modification of the requirements in section A3.3) when applied to a prior inforce or a model office is permitted if such modification facilitates validating the projection of inforce or the model office. All such modifications should be documented.

**A3.2) Basic and Basic Adjusted Reserve - Application of Actuarial Guideline XXXIII**

A) The Basic Reserve for a given contract shall be determined by applying statutory statement valuation requirements applicable immediately prior to adoption of the Guideline to the contract ignoring any guaranteed death benefits in excess of account values or guaranteed living benefits applying proceeds in excess of account values.

B) The calculation of the Basic Reserve shall assume a return on separate account assets based on the year of issue statutory valuation rate less appropriate asset based charges, including charges for any guaranteed death benefits or guaranteed living benefits. It shall also assume a return for any fixed separate account and general account options equal to the rates guaranteed under the contract.

C) The Basic Reserve shall be no less than the Cash Surrender Value on the valuation date, as defined in Section III)(B) of the Guideline.

D) The Basic Adjusted Reserve shall be that determined based on A3.2)A) and A3.2)B) except in A3.2)A) free partial withdrawal provisions shall be disregarded when determining surrender charges in applying the statutory statement valuation requirement prior to adoption of the Guideline. Section A3.2)(C) shall not apply to the Basic Adjusted Reserve.
A3.3) **Standard Scenario Reserve - Application of the Standard Scenario Method**

A) **General.** Where not inconsistent with the guidance given here, the process and methods used to determine the Standard Scenario Reserve under the Standard Scenario Method shall be the same as required in the calculation of the Conditional Tail Expectation Amount as described in Section IV) of the Guideline. Any additional assumptions needed to determine the Standard Scenario Reserve shall be explicitly documented.

B) **Results for the Standard Scenario Method.** For each contract, the Standard Scenario Reserve is the reserve based on 1) or 2) where:

1) For contracts without any guaranteed benefits, as defined in Section III)A) of the Guideline and where not subsequently disapproved by the Domiciliary Commissioner, the Standard Scenario Reserve is the Basic Reserve described in section A3.2)A), A3.2)B) and A3.2)C).

2) For all other contracts the Standard Scenario Reserve is equal to the greater of Cash Surrender Value on the valuation date, as defined in Section III)B) of the Guideline, and the quantity a) + b) - c), where:

   a) Is the Basic Adjusted Reserve calculated for the contract, as described in section A3.2)D);

   b) Is the greater of zero and the greatest present value at the Discount Rate measured as of the end of each projection year of the negative of the Accumulated Net Revenue described below using the assumptions described in A3.3)C). The Accumulated Net Revenue at the end of a projection year is equal to (i) + (ii) - (iii), where:

   i) Is the Accumulated Net Revenue at the end of the prior projection year accumulated at the Discount Rate to the end of the current projection year; the Accumulated Net Revenue at the beginning of the projection (i.e., time 0) is zero;

   ii) Are the margins generated during the projection year on account values accumulated at the Discount Rate to the end of the projection year (the factors and assumptions to be used in calculating the margins and account values are in A3.3)C)); and

   iii) Are the contract benefits in excess of account values applied, Individual reinsurance premiums and Individual reinsurance benefits payable or receivable during the projection year accumulated at the Discount Rate to the end of the projection year. Individual reinsurance is defined in A3.3)C)2).

   c) Is the contract’s allocation of the value of hedges and Aggregate reinsurance as described in section A3.3)D). Aggregate reinsurance is defined in section A3.3)C)2).

No reinsurance shall be considered in the Standard Scenario Amount if such reinsurance does not meet the statutory requirements that would allow the treaty to be accounted for as reinsurance. The actuary shall determine the projected reinsurance premiums and benefits reflecting all treaty limitations and assuming any options in the treaty to the other party are exercised to decrease the value of reinsurance to the reporting company (e.g., options to increase premiums or terminate coverage). The positive value of any reinsurance treaty that is not guaranteed to the insurer or its successor shall be excluded from the value of reinsurance. The commissioner may require the exclusion of a reinsurance treaty or any portion of a reinsurance treaty if the terms of the reinsurance treaty or the portion required to be excluded serves solely to reduce the calculated...
Appendix C

Standard Scenario Reserve without also reducing risk on scenarios similar to those used to determine the Conditional Tail Expectation Reserve. Any reinsurance reflected in the Standard Scenario Reserve shall be appropriate to the business and not merely constructed to exploit ‘foreknowledge’ of the components of the Standard Scenario Method.

C) Assumptions for use in paragraph A3.3)B)2)b) for Accumulated Net Revenue and Account Values.

1) Account Value Return Assumptions. The bases for return assumptions on assets supporting the Account Value are shown in Table I. The “Initial” returns shall be applied to the account value supported by each asset class on the valuation date as immediate drops, resulting in the Account Value at time 0. The “Year 1,” “Years 2 – 5,” and “Year 6+” returns for the equity, bond and balanced classes are gross annual effective rates of return and are used (along with other decrements and/or increases) to produce the Account Value as of the end of each projection interval. For purposes of this section, money market funds supporting Account Value shall be considered part of the Bond class.

The Fixed Fund rate is the greater of the minimum rate guaranteed in the contract or 4% but not greater than the current rates being credited to Fixed Funds on the valuation date.

Account Values shall be projected using the appropriate gross rates from Table I for equity, bond and balanced classes applied to the supporting assets less all fund and contract charges according to the provisions of the funds and contract and applying the Fixed funds rate from Table I as if it were the resulting net rate after deduction for fund or contract charges.

The annual margins on Account Value are defined as follows:

a) During the Surrender Charge Amortization Period, as determined following the step outlined in section A3.3)E) below:
   (i) 0.20% of Account Value; plus
   (ii) Any Net Revenue Sharing Income, as defined in section A1.1)E), that is contractually guaranteed to the insurer and its liquidator, receiver, and statutory successor; plus
   (iii) For all of the guaranteed living benefits of a given contract combined,\(^{14}\) the greater of:
         - 0.20% of Account Value; or
         - Explicit and optional contract charges for guaranteed living benefits; plus
   (iv) For all guaranteed death benefits of a given contract combined,\(^{15}\) the greater of:
       - 0.20% of Account Value; or
       - Explicit and optional contract charges for guaranteed death benefits.

b) After the Surrender Charge Amortization Period:

\(^{14}\) This excludes any guaranteed living benefit that is added to the contract simply for the purpose of increasing the revenue allowed under this section.

\(^{15}\) This excludes any guaranteed death benefit that is added to the contract simply for the purpose of increasing the revenue allowed under this section.
The amount determined in a) above; plus 50% of the excess, if any, of all contract charges (excluding Net Revenue Sharing Income) over the sum of a)(i), a)(iii) and a)(iv) above.

However, on fixed funds after the surrender charge period, a margin of up to the amount in a) above plus .4% may be used.

Table I

<table>
<thead>
<tr>
<th></th>
<th>Initial</th>
<th>Year 1</th>
<th>Years 2 – 5</th>
<th>Year 6+</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Class</td>
<td>-13.5%</td>
<td>0%</td>
<td>4.0%</td>
<td>5.50%</td>
</tr>
<tr>
<td>Bond Class</td>
<td>0%</td>
<td>0%</td>
<td>4.85%</td>
<td>4.85%</td>
</tr>
<tr>
<td>Balanced Class</td>
<td>-8.1%</td>
<td>0%</td>
<td>4.34%</td>
<td>5.24%</td>
</tr>
<tr>
<td>Fixed Separate Accounts and General Account (net)</td>
<td>0%</td>
<td>Fixed Fund Rate</td>
<td>Fixed Fund Rate</td>
<td>Fixed Fund Rate</td>
</tr>
</tbody>
</table>

2) **Reinsurance Credit.** Individual reinsurance is defined as reinsurance where the total premiums for and benefits of the reinsurance can be determined by applying the terms of the reinsurance to each contract covered without reference to the premiums or benefits of any other contract covered and summing the results over all contracts covered. Reinsurance that is not Individual is Aggregate.

Individual reinsurance premiums projected to be payable on ceded risk and receivable on assumed risk shall be included in the Projected Net Revenue. Similarly, Individual reinsurance benefits projected to be receivable on ceded risk and payable on assumed risk shall be included in the Projected Net Revenue. No Aggregate reinsurance shall be included in Projected Net Revenue.

3) **Lapses, Partial Withdrawals, and In-The-Moneyness.** Partial withdrawals elected as guaranteed living benefits, see A3.3)C)7), or required contractually (e.g., a contract operating under an automatic withdrawal provision on the valuation date) are to be deducted from the Account Value in each projection interval consistent with the projection frequency used, as described in A3.3)C)6), and according to the terms of the contract. No other partial withdrawals, including free partial withdrawals, are to be deducted from Account Value. All lapse rates should be applied as full contract surrenders.

For purposes of determining the dynamic lapse assumptions shown in Table II below, a guaranteed living benefit is in the money (ITM) for any projection interval if the Account Value at the beginning of the projection interval is less than the Current Value of the guaranteed living benefit (as defined below) also at the beginning of that projection interval.

The Current Value of the guaranteed living benefit at the beginning of any projection interval is either the amount of the current lump sum payment (if exercisable) or the present value of future lump sum or income payments. More specific guidance is provided below. For the purpose of determining the present value, the discount rate shall be equal $DR$ as defined in A3.1)B)2). If future living benefit payments are life contingent (i.e., either the right of future exercise or the right to future income benefits expires with...
the death of the annuitant or the owner), then the company shall determine the present value of such payments using the mortality table specified in A3.3)(C)(5).

If a guaranteed living benefit is exercisable (withdrawal can start or, in the case of a GMWB, has begun) at the beginning of the projection interval, then the Current Value of the guaranteed living benefit shall be determined assuming immediate or continued exercise of that benefit.

If a guaranteed living benefit is not exercisable (e.g., due to minimum age or duration requirements) at the beginning of that projection interval, then the Current Value of the guaranteed living benefit shall be determined assuming exercise of the guaranteed living benefit at the earliest possible future projection interval. If the right to exercise the guaranteed living benefit is contingent on the survival of the annuitant or the owner, then the Current Value of the guaranteed living benefit shall assume survival to the date of exercise using the mortality table specified in A3.3)(C)(5).

Determination of the Current Value of a guaranteed living benefit that is exercisable or payable at a future projection interval shall take account of any guaranteed growth in the basis for the guarantee (e.g., where the basis grows according to an index or an interest rate).

For a GMWB, the Current Value shall be determined assuming the earliest penalty-free withdrawal of guaranteed benefits after withdrawals begin and by applying the constraints of any applicable maximum or minimum withdrawal provisions. If the GMWB is currently exercisable and the right to future GMWB payments is contingent upon the survival of the annuitant or owner, then the Current Value shall assume survival using the mortality table specified in A3.3)(C)(5). After a GMWB that has payments that are contingent upon the survival of the annuitant or owner has commenced, then the Current Value shall assume survival using the Annuity 2000 Mortality Table.

For an unexercised GMIB, the Current Value shall be determined assuming the option with a reserve closest to the reserve for a 10 year certain and life option. The reserve values and the value of the GMIB on the assumed date of exercise shall be determined using the discount rate $DR$ specified in A3.1)(B)(2) and for life contingent payments, the Annuity 2000 Mortality Table. The Current Value of an unexercised GMIB, however, shall be set equal to the Account Value if the contractholder can receive higher income payments on the assumed date of exercise by electing the same option under the normal settlement option provisions of the contract.

For the purpose of applying the lapse assumptions specified in Table II below or contractholder elections rates specified in A3.3)(C)(7), the contract shall be considered “out of the money” (OTM) for a projection interval if the Current Value of the guaranteed living benefit at the beginning of the projection interval is less than or equal to the Account Value at the beginning of the same projection interval. If the Current Value of the guaranteed living benefit at the beginning of the projection interval is greater than the Account Value also at the beginning of the projection interval, the contract shall be considered ‘in the money’ (ITM) and the percent ITM shall equal:

$$100 \times \left( \frac{\text{Current Value of the guaranteed living benefit}}{\text{Account Value}} - 1 \right)$$

If a contract has multiple living benefit guarantees then the guarantee having the largest Current Value shall be used to determine the percent in the money.
Table II - Lapse Assumptions

<table>
<thead>
<tr>
<th></th>
<th>During Surrender Charge Period</th>
<th>After Surrender Charge Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Death Benefit Only Contracts</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>All Guaranteed Living Benefits OTM</td>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>Any Guaranteed Minimum Accumulation Benefit ITM</td>
<td>2%</td>
<td>ITM &lt; 10%</td>
</tr>
<tr>
<td>Any Other Guaranteed Living Benefits ITM</td>
<td>3%</td>
<td>ITM &lt; 10%</td>
</tr>
<tr>
<td></td>
<td>2%</td>
<td>10% &lt;= ITM &lt; 20%</td>
</tr>
<tr>
<td></td>
<td>7%</td>
<td>20% &lt;= ITM</td>
</tr>
</tbody>
</table>

4) **Account Transfers and Future Deposits.** No transfers between funds shall be assumed in the projection used to determine the greatest present value amount required under section A3.3)B)2)b) unless required by the contract (e.g., transfers from a dollar cost averaging fund or contractual rights given to the insurer to implement a contractually specified portfolio insurance management strategy or a contract operating under an automatic re-balancing option). When transfers must be modeled, to the extent not inconsistent with contract language, the allocation of transfers to funds must be in proportion to the contract’s current allocation to funds.

Margins generated during a projection interval on funds supporting account value are transferred to the Accumulation of Net Revenue and are subsequently accumulated at the Discount Rate. Assets for each class supporting account values are to be reduced in proportion to the amount held in each asset classes at the time of transfer of margins or any portion of Account Value applied to the payment of benefits.

No future deposits to Account Value shall be assumed unless required by the terms of the contract to prevent contract or guaranteed benefit lapse, in which case they must be modeled. When future deposits must be modeled, to the extent not inconsistent with contract language, the allocation of the deposit to funds must be in proportion to the contract’s current allocation to such funds.

5) **Mortality.** Mortality at 70% of the 1994 Variable Annuity MGDB Mortality Tables (1994 MGDB tables) through age 85 increasing by 1% each year to 100% of the 1994 MGDB tables at age 115 shall be assumed in the projection used to determine the greatest present value amount required under section A3.3)B)2)b).

6) **Projection Frequency.** The projection used to determine the greatest present value amount required under section A3.3)B)2)b) shall be calculated using an annual or more frequent time step, such as quarterly. For time steps more frequent than annual, assets supporting Account Values at the start of a year may be retained in such funds until year-end (i.e., margin earned during the year will earn the fund rates instead of the Discount Rate until year end) or removed after each time step. However, the same approach shall be applied for all years. Similarly, projected benefits, lapses, elections and other contractholder activity can be assumed to occur annually or at the end of each time step, but the approach shall be consistent for all years.
7) **Contractholder Election Rates.** Contractholder election rates for exercisable ITM guaranteed living benefits other than GMWBs shall be 5% per annum in every projection interval where the living benefit is less than 10% ITM, 15% per annum in every projection interval where the living benefit is 10% or more ITM and less than 20% ITM, and 25% per annum in every projection interval where the living benefit is more than 20% ITM. In addition, the election rate for an exercisable ITM guaranteed living benefit shall be 100% at the last model duration to elect such benefit. This 100% election rate shall be used when a Guaranteed Minimum Accumulation Benefit is at the earliest date that the benefit is exercisable and in-the-money. However, the contractholder election rate for any exercisable ITM guaranteed living benefit shall be zero if exercise would cause the extinction of a guaranteed living benefit having a larger Current Value. For this purpose, GMDBs are not benefits subject to election.

For guaranteed minimum withdrawal benefits, a partial withdrawal, if allowed by contract provisions, equal to the applicable percentage in Table III applied to the contract’s maximum allowable partial withdrawal shall be assumed. However, if the contract’s minimum allowable partial withdrawal exceeds the partial withdrawal from applying the rate in Table III to the contract’s maximum allowable partial withdrawal, then the contract’s minimum allowable partial withdrawal shall be assumed.

<table>
<thead>
<tr>
<th>Table III - Guaranteed Withdrawal Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attained Age less than 50</td>
</tr>
<tr>
<td>Withdrawals do not reduce other elective Guarantees that are in the money</td>
</tr>
<tr>
<td>Withdrawals reduce elective Guarantees that are in the money</td>
</tr>
</tbody>
</table>

8) **Indices.** If an interest index is required to determine projected benefits or reinsurance obligations, the index must assume interest rates have not changed since the last reported rates before the valuation date. If an equity index is required the index shall be consistent with the last reported index before the valuation date, the initial drop in equity returns and the subsequent equity returns in the standard scenario projection. The sources of information and how they are used to determine the indexes shall be documented and, to the extent possible, consistent from year to year.

D) **Assumptions for use in Section A3.3)B)2)c).**

1) **The Value of Aggregate Reinsurance.** The value of Aggregate reinsurance shall be calculated separately from the Accumulated Net Revenue. The value of Aggregate reinsurance is the discounted value, using the statutory valuation rate described in the following paragraph, of the excess of (a) the projected benefit payments from the reinsurance; over (b) the projected gross reinsurance premiums, where (a) and (b) are determined under the assumptions described in section A3.3)C) for all applicable contracts in aggregate.

In order for the value of the Aggregate reinsurance to be consistent with the underlying Standard Scenario reserve, the discount rate shall be a weighted average of the valuation rates (DR) of the contracts that are supported by the Aggregate reinsurance treaty. The
weights used to determine this discount rate shall be reasonably related to the risks that are being covered by the Aggregate reinsurance (e.g., account value or values of guaranteed benefits) and shall be applied consistently from year to year. If an appropriate method to determine this discount rate does not exist, the value of the Aggregate reinsurance shall be determined using the statutory valuation rate in effect on the valuation date for annuities valued on an issue year basis using Plan Type A and a Guarantee Duration greater than 10 years but not more than 20 years, determined assuming there are cash settlement options but no interest guarantees on future premiums.

2) The Value of Approved Hedges. The value of approved hedges shall be calculated separately from the Accumulated Net Revenue. The value of approved hedges is the difference between: a) the discounted value at the 1-year CMT\textsuperscript{16} as of the valuation date of the pre-tax cash flows from the approved hedges; less b) their statement values on the valuation date.

To be an approved hedge for purposes of the Standard Scenario Reserve, a derivative or other investment has to be an actual asset held by the company on the valuation date, be used as a hedge supporting the contracts falling under the scope of the Guideline, and comply with any statutes, laws, or regulations (including applicable documentation requirements) of the domiciliary state or jurisdiction related to the use of derivative instruments.

The Domiciliary Commissioner may require the exclusion of any portion of the value of approved hedges upon a finding that the company’s documentation, controls, measurement, execution of strategy or historical results are not adequate to support a future expectation of risk reduction commensurate with the value of approved hedges.

The cash flow projection for approved hedges that expire in less than one year from the valuation date should be based on holding the hedges to their expiration. For hedges with an expiration of more than 1 year, the value of hedges should be based on liquidation of the hedges one year from the valuation date. Where applicable, the liquidation value of hedges shall be consistent with the assumed returns in the Standard Scenario from the start of the projection to the date of liquidation, Black-Scholes pricing, a risk free rate equal to the 5-year CMT as of the valuation date and the annual volatility implicit as of the valuation date in the statement value of the hedges when the statement value of hedges are valued with Black-Scholes pricing and a risk-free rate equal to the 5-year CMT as of the valuation date.\textsuperscript{17}

There is no credit in the Standard Scenario for dynamic hedging beyond the credit that results from hedges actually held on the valuation date.

3) Allocation of the Value of Hedges and the Value of Aggregate Reinsurance. The value of approved hedges and Aggregate reinsurance shall be allocated to the contracts which are

\textsuperscript{16}For purposes of this Appendix, the term CMT refers to the nominal yields on actively traded non-inflation-indexed issues adjusted to constant maturities, as released daily by the Federal Reserve Board. As of this writing, the current and historical one-year rates may be found at http://www.federalreserve.gov/releases/h15/data/Business_day/H15_TCMNOM_Y1.txt and the current and historical five-year rates may be found at http://www.federalreserve.gov/releases/h15/data/Business_day/H15_TCMNOM_Y5.txt.

\textsuperscript{17}Conceptually, the item being hedged, the contract guarantees, and the approved hedges are accounted for at the average present value of the worst 30% of all scenarios, the tail scenarios for a CTE (70) measure. However, the statement value of approved hedges is at market. Therefore, the standard scenario value of approved hedges is a proxy of the adjustment needed to move approved hedges from a market value to a tail value.
supported by the applicable Aggregate reinsurance agreements and approved hedges. A contract’s allocation shall be the lesser of the amount in A3.3)(B)(2)(b) for the contract or the product of a) and b) where:

a) Is the sum of the value of the applicable approved hedges plus the value of the applicable Aggregate reinsurance for all contracts supported by the same hedges and/or the Aggregate reinsurance agreement; and

b) Is the ratio of the amount in A3.3)(B)(2)(b) for the contract to the sum of the amount in A3.3)(B)(2)(b) for all contracts supported by the same hedges and/or the Aggregate reinsurance agreement.

4) Retention of components. For the seriatim Standard Scenario Reserve on the statement date under each of Sections A3.1)(B)(1) and A3.1)(B)(2), the actuary should have available to the Commissioner the following values for each contract:

a) The Standard Scenario Reserve prior to adjustment under paragraph A3.3)(D)(3)


E) Determination of the Surrender Charge Amortization Period to be used in section A3.3)(C)(1)(a) and b).

The purpose of the Surrender Charge Amortization Period is to help determine how much of the surrender charge is amortized in the Basic Adjusted Reserve portion of the Standard Scenario Amount and how much needs to be amortized in the Accumulated Net Revenue portion. Once determined, the Surrender Charge Amortization Period determines the duration over which the lower level of margins, as described in A3.3)(C)(1)(a), is used. After that duration, the higher level of margins, as described in A3.3)(C)(1)(b), is used.

A separate Surrender Charge Amortization Period is determined for each contract and is based on amounts determined in the calculation of the Basic Adjusted Reserve for that contract. A key component of the calculation is the amount of the surrender charge that is not amortized in the Basic Adjusted Reserve calculation for that contract. This is represented by the difference between the account value and the cash surrender value projected within the Basic Adjusted Reserve calculation for the contract.

The Surrender Charge Amortization Period for a given contract is determined by following the steps:

1) Measure the duration of the greatest present value used in the Basic Adjusted Reserve. The Basic Adjusted Reserve is determined for a contract by taking the greatest present value of a stream of projected benefits. The benefit stream that determines the greatest present value typically includes an “ultimate” event (e.g., 100% surrender, 100% annuitization, or maturity). The “BAR Duration” is the length of time between the valuation date and the projected “ultimate” event.

2) Determine the amount of the surrender charge not amortized in the Basic Adjusted Reserve. The surrender charge not amortized in the Basic Adjusted Reserve is the difference between the projected account value and the projected cash surrender value at the BAR Duration (i.e., at the time of that projected “ultimate” event). This value for a given contract shall not be less than zero.

3) Determine the Surrender Charge Amortization Period before rounding. This equals a) time b) plus c), where:

a) Equals the ratio of the amount determined in step 2 to the Account Value on the valuation date;
b) Equals 100; and

c) Equals the BAR Duration determined in step 1.

4) Determine the Surrender Charge Amortization Period for the contract. This is the amount determined in step 3, rounded to the nearest number that represents a projection duration, taking into account the projection frequency described in A3.3)(C)6). For example, step 3 produces a value of 2.15 and the projection frequency is quarterly, the Surrender Charge Amortization Period for the contract is 2.25.
APPENDIX 4 - Alternative Methodology

A4.1) General Methodology

A) General Methodology Description. For variable deferred annuity contracts that either contain no guaranteed benefits or only GMDBs (i.e., no VAGLBs), the Conditional Tail Expectation Amount may be determined by using the method outlined below rather than by using the approach described in Section IV)D) (i.e., based on projections), provided the approach described in Section IV)D) has not been used in prior valuations or else approval has been obtained from the Domiciliary Commissioner.

The Conditional Tail Expectation Amount determined using the Alternative Methodology for a group of contracts with GMDBs shall be determined as the sum of amounts obtained by applying factors to each contract in force as of a valuation date and adding this to the contract’s Cash Surrender Value. The resulting Conditional Tail Expectation Amount shall not be less than the Cash Surrender Value in aggregate for the group of contracts to which the Alternative Methodology is applied.

The Conditional Tail Expectation Amount determined using the Alternative Methodology for a group of contracts that contain no guaranteed benefits shall be determined using an application of Actuarial Guideline XXXIII, as described below.

For purposes of performing the Alternative Methodology, materially similar contracts within the group may be combined together into subgroups to facilitate application of the factors. Specifically, all contracts comprising a “subgroup” must display substantially similar characteristics for those attributes expected to affect reserves (e.g., definition of guaranteed benefits, attained age, contract duration, years-to-maturity, market-to-guaranteed value, asset mix, etc.). Grouping shall be the responsibility of the actuary but may not be done in a manner that intentionally understates the resulting reserve.

B) Definitions of Terms Used in this Appendix.

1) Annualized Account Charge Differential. This term is the charge as percentage account value (revenue for the company) minus the expense as percentage of account value.

2) Asset Exposure. Asset Exposure refers to the greatest possible loss to the insurance company from the value of assets underlying general or separate account contracts falling to zero.

3) Benchmark. Benchmarks have similar risk characteristics to the entity (e.g., asset class, index, or fund) to be modeled.

4) Deterministic Calculations. In a Deterministic Calculation, a given event (e.g., asset returns going up by 7% then down by 5%) is assumed to occur with certainty. In a stochastic calculation, events are assigned probabilities.

5) Foreign Securities. Securities issued by entities outside the United States and Canada.

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18 This includes “earnings enhanced death benefits,” as discussed in Section III)A)1).
19 The amount that is added to a contract's Cash Surrender Value may be negative, zero or positive, thus resulting in a reserve for a given contract that could be less than, equal to, or greater than, the Cash Surrender Value.
20 The term “contracts that contain no guaranteed benefits” means that there are no guaranteed benefits at any time during the life of the contract (past, present or future).
6) **Grouped Fund Holdings.** Grouped Fund Holdings relate to guarantees that apply across multiple deposits or for an entire contract instead of on a deposit-by-deposit basis.

7) **Guaranteed Value.** The Guaranteed Value is the benefit base or a substitute for the account value (if greater than the account value) in the calculation of living benefits or death benefits. The methodology for setting the Guaranteed Value is defined in the variable annuity contract.

8) **High-Yield Bonds.** High-Yield Bonds are below investment grade, with NAIC ratings (if assigned) of 3, 4, 5, or 6. Compared to investment grade bonds, these bonds have higher risk of loss due to credit events. Funds containing securities predominately containing securities that are not NAIC rated as 1 or 2 (or similar agency ratings) are considered to be High-Yield.

9) **Investment Grade Fixed Income Securities.** Securities with NAIC ratings of 1 or 2 are Investment Grade. Funds containing securities predominately with NAIC ratings of 1 or 2 or with similar agency ratings are considered to be Investment Grade.

10) **Liquid Securities.** These securities can be sold and converted into cash at a price close to its true value in a short period of time.

11) **Margin Offset.** Margin Offset is the portion of charges plus any Revenue Sharing allowed under section A1.1(E) available to fund claims and amortization of the unamortized surrender charges allowance.

12) **Multi-Point Linear Interpolation.** This methodology is documented in mathematical literature and calculates factors based on multiple attributes categorized with discrete values where the attributes’ actual values may be between the discrete values.

13) **Model Office.** A Model Office converts many contracts with similar features into one contract with specific features for modeling purposes.

14) **Pre-Packaged Scenarios.** The Pre-Packaged Scenarios are the year-by-year asset returns that may be used (but are not mandated) in projections related to the alternative methodology. These scenarios are available on an American Academy of Actuaries website.

15) **Quota-Share Reinsurance.** In this type of reinsurance treaty, the same proportion is ceded on all cessions. The reinsurer assumes a set percentage of risk for the same percentage of the premium, minus an allowance for the ceding company’s expenses.

16) **Resets.** A Reset benefit results in a future minimum guaranteed benefit being set equal to the contract’s account value at previous set date(s) after contract inception.

17) **Risk Mitigation Strategy.** A Risk Mitigation Strategy is a device to reduce the probability and/or impact of a risk below an acceptable threshold.

18) **Risk Profile.** Risk Profile in the Guideline relates to the prescribed asset class categorized by the volatility of returns associated with that class.

19) **Risk Transfer Arrangements.** A Risk Transfer Arrangement shifts risk exposures (e.g., the responsibility to pay at least a portion of future contingent claims) away from the original insurer.
20) **Roll-Up.** A Roll-Up benefit results in the guaranteed value associated with a minimum contractual guarantee increasing at a contractually defined interest rate.

21) **Volatility.** Volatility refers to the annualized standard deviation of asset returns.

C) **Contract-by-Contract Application for Contracts that Contain No Guaranteed Living or Death Benefits.** The Alternative Methodology reserve for each contract that contains no guaranteed living or death benefits shall be determined by applying Actuarial Guideline XXXIII. The application shall assume a return on separate account assets equal to the year of issue valuation interest rate less appropriate asset based charges. It shall also assume a return for any fixed separate account and general account options equal to the rates guaranteed under the contract.

The reserve for such contracts shall be no less than the Cash Surrender Value on the valuation date, as defined in Section III)B).

D) **Contract-by-Contract Application for Contracts that Contain GMDBs only.** For each contract, factors are used to determine a dollar amount, equal to \( R \times (CA + FE) + GC \) (as described below), that is to be added to that contract’s Cash Surrender Value as of the valuation date. The dollar amount to be added for any given contract may be negative, zero, or positive. The factors that are applied to each contract shall reflect the following attributes as of the valuation date:

1) The contractual features of the variable annuity product,

2) The actual issue age, period since issue, attained age, years-to-maturity, and gender applicable to the contract,

3) The account value and composition by type of underlying variable or fixed fund,

4) Any surrender charges,

5) The GMDB and the type of adjustment made to the GMDB for partial withdrawals (e.g., proportional or dollar-for-dollar adjustment), and

6) Expenses to be incurred and revenues to be received by the company as estimated on a Prudent Estimate basis as described in Section III)B)8) and complying with the requirements for Revenue Sharing as described in section A1.1)E).

E) **Factor Components.** Factors shall be applied to determine each of the following components: \(^{21}\)

\[
CA = \text{Provision for amortization of the unamortized surrender charges calculated by the insurer based on each contract’s surrender charge schedule, using prescribed assumptions, except that lapse rates shall be based on the insurer’s Prudent Estimate, but with no provision for Federal Income Taxes or mortality;}
\]

\[
FE = \text{Provision for fixed dollar expenses less fixed dollar revenue calculated using prescribed assumptions, the contract’s actual expense charges, the insurer’s anticipated actual expenses and lapse rates, both estimated on a Prudent Estimate basis, and with no provision for Federal Income Taxes or mortality;}
\]

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AG XLIII  
Appendix C

| \(GC\) | Provision for the costs of providing the GMDB less net available spread-based charges determined by the formula \(F \times GV - G \times AV \times R\), where \(GV\) and \(AV\) are as defined in section A4.3)A); |
| \(R\) | A scaling factor that is a linear function of the ratio of the margin offset to Total Account Charges \((W)\) and takes the form \(R(\beta_0, \beta_1) = \beta_0 + \beta_1 \times W\). The intercept and slope factors for this linear function vary according to: |
| a) | Product type, |
| b) | Pro-rata or dollar-for-dollar reductions in guaranteed value following partial withdrawals, |
| c) | Fund class, |
| d) | Attained age, |
| e) | Contract duration, |
| f) | Asset-based charges, and |
| g) | 90% of the ratio of account value to guaranteed value, determined in the aggregate for all contracts sharing the same product characteristics. |

Tables of factors for \(F\), \(G\), \(\beta_0\), and \(\beta_1\) values, reflecting a 65% confidence level and ignoring Federal Income Tax, are available from the National Association of Insurance Commissioners. In calculating \(R(\beta_0, \beta_1)\) directly from the linear function provided above, the margin ratio \(W\) must be constrained to values greater than or equal to 0.2 and less than or equal to 0.6.

Interpolated values of \(F\), \(G\) and \(R\) (calculated using the linear function described above) for all contracts having the same product characteristics and asset class shall be derived from the pre-calculated values using multi-point linear interpolation over the following four contract-level attributes:

1) Attained age,  
2) Contract duration,  
3) Ratio of account value to GMDB, and  
4) The total of all asset based charges, including any fund management fees or allowances based on the underlying variable annuity funds received by the insurer.

The gross asset-based charges for a product shall equal the sum of all contractual asset-based charges plus fund management fees or allowances based on the underlying variable annuity funds received by the insurer determined by complying with the requirements for Prudent Estimate described in Section III)B)8) and Revenue Sharing described in section A1.1)E). Net asset-based charges equal gross asset-based charges less any company expenses assumed to be incurred expressed as a percentage of account value. All expenses that would be assumed if the Conditional Tail Expectation Amount were being computed as described in section A1.1)A) should be reflected either in the calculation of the net asset based charges or in the expenses reflected in the calculation of the amount \(FE\).

No adjustment is made for Federal Income Taxes in any of the components listed above.
For purposes of determining the Conditional Tail Expectation Amount using the Alternative Methodology, any interpretation and application of the requirements of the Guideline shall follow the principles discussed in the Section I) Background.

**A4.2) Calculation of CA and FE**

**A) General Description.** Components CA and FE shall be calculated for each contract, thus reflecting the actual account value and GMDB, as of the valuation date, which is unique to each contract.

Components CA and FE are defined by deterministic “single-scenario” calculations that account for asset growth, interest and inflation at prescribed rates. Mortality is ignored for these two components. Lapse rates shall be determined on a Prudent Estimate basis as described in Section III(B)8). Lapse rates shall be adjusted by the formula shown below (the Dynamic Lapse Multiplier, \( \lambda \)), which bases the relationship of the GMDB (denoted as GV in the formula) to the account value (denoted as AV in the formula) on the valuation date. Thus, projected lapse rates are smaller when the GMDB is greater than the account value and larger when the GMDB is less than the account value.

\[
\lambda = \text{MIN} \left[ U, \text{MAX} \left[ L, 1 - M \times \left( \frac{GV}{AV} - D \right) \right] \right],
\]

where \( U=1, L=0.5, M=1.25, \) and \( D=1.1. \)

Present values shall be computed over the period from the valuation date to contract maturity at a discount rate of 5.75%.

Projected fund performance underlying the account values is as shown in the table below. Unlike the GC component, which requires the entire account value to be mapped, using the Fund Categorization Rules set forth in section A4.4, to a single “equivalent” asset class (as described in A4.4(C)), the CA and FE calculation separately projects each variable subaccount (as mapped to the 8 prescribed categories shown in section A4.4)) using the net asset returns shown in the following table. If surrender charges are based wholly on deposits or premiums as opposed to account value, use of this table may not be necessary.

<table>
<thead>
<tr>
<th>Asset Class / Fund</th>
<th>Net Annualized Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Account</td>
<td>Guaranteed Rate</td>
</tr>
<tr>
<td>Money Market</td>
<td>0%</td>
</tr>
<tr>
<td>Fixed Income (Bond)</td>
<td>0%</td>
</tr>
<tr>
<td>Balanced</td>
<td>-1%</td>
</tr>
<tr>
<td>Diversified Equity</td>
<td>-2%</td>
</tr>
<tr>
<td>Diversified International Equity</td>
<td>-3%</td>
</tr>
<tr>
<td>Intermediate Risk Equity</td>
<td>-5%</td>
</tr>
<tr>
<td>Aggressive or Exotic Equity</td>
<td>-8%</td>
</tr>
</tbody>
</table>

**B) Component CA.** Component CA is computed as the present value of the projected change in surrender charges plus the present value of an implied borrowing cost of 25 basis points at the beginning of each future period applied to the surrender charge at such time.
This component can be interpreted as the “amount needed to amortize the unamortized surrender charge allowance for the persisting policies plus the implied borrowing cost.” By definition, the amortization for non-persisting lives in each time period is exactly offset by the collected surrender charge revenue (ignoring timing differences and any waiver upon death). The unamortized balance must be projected to the end of the surrender charge period using the net asset returns and Dynamic Lapse Multiplier, $\lambda$, both as described above and the year-by-year amortization discounted also as described above. For simplicity, mortality is ignored in the calculations. Surrender charges and free partial withdrawal provisions are as specified in the contract. Lapse and withdrawal rates are determined on a Prudent Estimate basis, and may vary according to the attributes of the business being valued, including, but not limited to, attained age, contract duration, etc.

C) Component FE. Component FE establishes a provision for fixed dollar expenses (e.g., allocated costs, including overhead expressed as “per contract” and those expenses defined on a “per contract” basis) less any fixed dollar revenue (e.g., annual administrative charges or contract fees) through the earlier of contract maturity or 30 years. FE is computed as the present value of the company’s assumed fixed expenses projected at an assumed annual rate of inflation starting in the second projection year. This rate grades uniformly from the current inflation rate (“CIR”) into an ultimate inflation rate of 3% per annum in the 8th year after the valuation date. The CIR is the greater of 3% and the inflation rate assumed for expenses in the company’s most recent asset adequacy analysis for similar business.

A4.3) Calculation of the GC Component

A) GC Factors. GC is calculated as $F \times GV - G \times AV \times R$, where $GV$ is the amount of GMDB and $AV$ is the contract account value, both as of the valuation date. $F$, $G$ and the slope and intercept for the linear function used to determine $R$ (identified symbolically as $\beta_0$ and $\beta_1$) are pre-calculated factors available from the National Association of Insurance Commissioners and known herein as the “Pre-Calculated Factors.” These factors shall be interpolated as described in subsection F), below, and modified as necessary as described in sections A4.3)G) and A4.3)H).

B) Five Steps. There are five major steps in determining the GC component for a given contract:

1) Classifying the asset exposure (as specified in subparagraph C), below);

2) Determining the risk attributes (as specified in subparagraphs D) and E), below);

3) Retrieving the appropriate nodal factors from the factor grid (as described in subparagraph F) below);

4) Interpolating the nodal factors, where applicable (optional) also as described in subparagraph F), below; and

5) Applying the factors to the contract values.

C) Classifying Asset Exposure. For purposes of calculating GC (unlike what is done for components CA and FE), the entire account value for each contract must be assigned to one of the eight prescribed fund classes shown in section A4.4), using the Fund Categorization rules in section A4.4).

D) Product Designs. Factors $F$, $G$ and $R(\beta_1, \beta_2)$ are available within the Pre-Calculated Factors for the following GMDB product designs:
1) Return of Premium (“ROP”),

2) Premiums less withdrawals accumulated at 3% per annum, capped at 2.5 times premiums less withdrawals, with no further increase beyond age 80 (“ROLL3”),

3) Premiums less withdrawals accumulated at 5% per annum, capped at 2.5 times premiums less withdrawals, with no further increase beyond age 80 (“ROLL5”),

4) An annual ratchet design (maximum anniversary value), for which the guaranteed benefit never decreases and is increased to equal the previous contract anniversary account value, if larger, with no further increases beyond age 80 (“MAV”),

5) A design having a guaranteed benefit equal to the larger of the benefits in designs 3 and 4, above (“HIGH”),

6) An enhanced death benefit (“EDB”) equal to 40% of the net earnings on the account (i.e., 40% of account value less total premiums paid plus withdrawals made) with this latter benefit capped at 40% of premiums less withdrawals (“EDB”),

E) Other Attributes. Factors $F$, $G$ and $R(\beta_1, \beta_2)$ are available within the Pre-Calculated Factors for the following set of attributes:

1) Two Partial Withdrawal Rules – one for contracts having a pro-rata reduction in the GMDB and another for contracts having a dollar-for-dollar reduction,

2) The eight asset classes described in section A4.4)B),

3) Eight attained ages, with a 5-year age setback for females,

4) Five contract durations,

5) Seven values of GV/AV, and

6) Three levels of asset-based income.

F) Interpolation of $F$, $G$ and $R(\beta_1, \beta_2)$.

1) Values of $F$, $G$ and $R(\beta_1, \beta_2)$ apply to a contract having the product characteristics listed in section A4.5)A) and shall be determined by selecting values for the appropriate partial withdrawal rule and asset class and then using multi-point linear interpolation among published values for the last four attributes shown in section A4.3)E).

2) Interpolation over all four dimensions is not required, but if not performed over one or more dimensions, the factor used must result in a conservative (higher) value of $GC$. However, simple linear interpolation using the $AV/GV$ ratio is mandatory. In this case, the company must choose nodes for the other three dimensions according to the following rules: next highest attained age, nearest duration, and nearest Annualized Account Charge Differential, as listed in A4.5)C) (i.e., capped at +100 and floored at –100 bps).
3) For \( R(\beta_1, \beta_2) \), the interpolation should be performed on the Scaling Factors \( R \) calculated using \( \beta_1, \beta_2 \), using the ratio of Margin Offset to Total Asset Charges \( (W) \), not on the factors \( \beta_1 \) and \( \beta_2 \) themselves.

4) An Excel® workbook, Excel® add-in and companion dynamic link library (.dll) program is available from the National Association of Insurance Commissioners that can be used to determine the correct values and perform the multi-point linear interpolation.

5) Alternatively, published documentation can be referenced on performing multi-point linear interpolation and the required sixteen values determined using a key that is documented in the table “Components of Key Used for GC Factor Look-Up” located in section A4.5(C).

G) Adjustments to GC for Product Variations & Risk Mitigation/Transfer. In some cases, it may be necessary to make adjustments to the published factors due to:

1) A variation in product form wherein the definition of the guaranteed benefit is materially different from those for which factors are available (see section A4.3(H)); and/or

2) A risk mitigation or other management strategy, other than a hedging strategy, that cannot be accommodated through a straightforward and direct adjustment to the published values.

Adjustments may not be made to GC for hedging strategies.

Any adjustments to the published factors must be fully documented and supported through stochastic analysis. Such analysis may require stochastic simulations, but would not ordinarily be based on full inforce projections. Instead, a representative “model office” should be sufficient. Use of these adjusted factors must be supported by a periodic review of the appropriateness of the assumptions and methods used to perform the adjustments, with changes made to the adjustments when deemed necessary by such review.

Note that minor variations in product design do not necessarily require additional effort. In some cases, it may be reasonable to use the factors/formulas for a different product form (e.g., for a roll-up GMDB near or beyond the maximum reset age or amount, the ROP GMDB factors/formulas shall be used, possibly adjusting the guaranteed value to reflect further resets, if any). In other cases, the reserves may be based on two different guarantee definitions and the results interpolated to obtain an appropriate value for the given contract/cell. Likewise, it may be possible to adjust the Alternative Methodology results for certain risk transfer arrangements without significant additional work (e.g., quota-share reinsurance without caps, floors or sliding scales would normally be reflected by a simple pro-rata adjustment to the “gross” GC results).

However, if the contract design is sufficiently different from those provided and/or the risk mitigation strategy is non-linear in its impact on the Conditional Tail Expectation Amount, and there is no practical or obvious way to obtain a good result from the prescribed factors/formulas, any adjustments or approximations must be supported using stochastic modeling. Notably this modeling need not be performed on the whole portfolio, but can be undertaken on an appropriate set of representative policies.

H) Adjusting F and G for Product Design Variations. This subsection describes the typical process for adjusting \( F \) and \( G \) factors due to a variation in product design. Note that \( R \) (as determined by the slope and intercept terms in the factor table) would not be adjusted.
1) Select a contract design among those described in section A4.3)D) that is similar to the product being valued. Execute cash flow projections using the documented assumptions (see table of Liability Modeling Assumptions & Product Characteristics in section A4.5)A) and table of Asset Based Fund Charges in section A4.5)B)) and the pre-packaged scenarios for a set of representative cells (combinations of attained age, contract duration, asset class, AV/GMDB ratio and asset-based charges). These cells should correspond to nodes in the table of pre-calculated factors. Rank (order) the sample distribution of results for the present value of net cost. Determine those scenarios that comprise CTE (65).

2) Using the results from step 1, average the present value of cost for the CTE (65) scenarios and divide by the current guaranteed value. For the \( J^{th} \) cell, denote this value by \( \overline{F}_J \). Similarly, average the present value of margin offset revenue for the same subset of scenarios and divide by account value. For the \( J^{th} \) cell, denote this value by \( \overline{G}_J \).

3) Extract the corresponding pre-calculated factors. For each cell, calibrate to the published tables by defining a “model adjustment factor” (denoted by asterisk) separately for the “cost” and “margin offset” components:

\[
F_J^* = \frac{\bar{f}(\theta)}{\overline{F}_J} \quad \text{and} \quad G_J^* = \frac{\bar{g}(\theta)}{\overline{G}_J}
\]

4) Execute “product specific” cash flow projections using the documented assumptions and pre-packaged scenarios for the same set of representative cells. Here, the company should model the actual product design. Rank (order) the sample distribution of results for the present value of net cost. Determine those scenarios that comprise CTE (65).

5) Using the results from step 4, average the present value of cost for the CTE (65) scenarios and divide by the current guaranteed value. For the \( J^{th} \) cell, denote this value by \( \overline{F}_J \). Similarly, average the present value of margin offset revenue for the same subset of scenarios and divide by account value. For the \( J^{th} \) cell, denote this value by \( \overline{G}_J \).

6) To calculate the Conditional Tail Expectation Amount for the specific product in question, the company should implement the Alternative Methodology as documented, but use \( \overline{F}_J \times F_J^* \) in place of \( F \) and \( \overline{G}_J \times G_J^* \) instead of \( G \). The same \( R \) factors as appropriate for the product evaluated in step 1 shall be used for this step (i.e., the product used to calibrate the cash flow model).

1) Adjusting GC for Mortality Experience. The factors that have been developed for use in determining GC assume male mortality at 100% of the 1994 Variable Annuity MGDB ALB Mortality Table. Companies electing to use the Alternative Methodology that have not conducted an evaluation of their mortality experience shall use these factors. Other companies should use the procedure described below to adjust for the actuary’s Prudent Estimate of mortality. The development of Prudent Estimate mortality shall follow the requirements and guidance of Appendix 10. Once a company uses the modified method for a block of business, the option to use the unadjusted factors is no longer available for that part of its business. In applying the factors to actual inforce business, a 5-year age setback should be used for female annuitants.

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22 Present value of net cost = PV[ guaranteed benefit claims in excess of account value ] – PV[ margin offset ]. The discounting includes cash flows in all future years (i.e., to the earlier of contract maturity and the end of the horizon).
1) Develop a set of mortality assumptions based on Prudent Estimate. In setting these assumptions, the actuary shall be guided by the definition of Prudent Estimate and the principles discussed in Appendices 9 and 10 of the Guideline.

2) Calculate two sets of net single premiums (NSP) at each attained age: one valued using 100% of the 1994 Variable Annuity MGDB ALB Mortality Table (with the aforementioned 5-year age setback for females) and the other using Prudent Estimate mortality. These calculations shall assume an interest rate of 3.75% and a lapse rate of 7% per year.

3) The GC factor is multiplied by the ratio, for the specific attained age being valued, of the NSP calculated using the Prudent Estimate mortality to the NSP calculated using the 1994 Variable Annuity MGDB ALB Mortality Table (with the aforementioned 5-year age setback for females).

A4.4) Fund Categorization

A) Criteria. The following criteria should be used to select the appropriate factors, parameters and formulas for the exposure represented by a specified guaranteed benefit. When available, the volatility of the long-term annualized total return for the fund(s) – or an appropriate benchmark – should conform to the limits presented. For this purpose, “long-term” is defined as twice the average projection period that would be applied to test the product in a stochastic model (generally, at least 30 years).

Where data for the fund or benchmark are too sparse or unreliable, the fund exposure should be moved to the next higher volatility class than otherwise indicated. In reviewing the asset classifications, care should be taken to reflect any additional volatility of returns added by the presence of currency risk, liquidity (bid-ask) effects, short selling and speculative positions.

B) Asset Classes. Variable subaccounts must be categorized into one of the following eight (8) asset classes. For purposes of calculating CA or FE, each contract will have one or more of the following asset classes represented, whereas for component GC, all subaccounts will be mapped into a single asset class.

1) Fixed Account. This class is credited interest at guaranteed rates for a specified term or according to a ‘portfolio rate’ or ‘benchmark’ index. This class offers a minimum positive guaranteed rate that is periodically adjusted according to company policy and market conditions.

2) Money Market/Short-Term. This class is invested in money market instruments with an average remaining term-to-maturity of less than 365 days.

3) Fixed Income. This class is invested primarily in investment grade fixed income securities. Up to 25% of the funds within this class may be invested in diversified equities or high-yield bonds. The expected volatility of the returns for this class will be lower than the Balanced fund class.

4) Balanced. This class is a combination of fixed income securities with a larger equity component. The fixed income component should exceed 25% of the portfolio. Additionally, any aggressive or ‘specialized’ equity component should not exceed one-third (33.3%) of the total equities held. Should the fund violate either of these constraints, it should be categorized as an equity fund. This class usually has a long-term volatility in the range of 8% – 13%.
5) **Diversified Equity.** This class is invested in a broad-based mix of U.S. and foreign equities. The foreign equity component (maximum 25% of total holdings) must be comprised of liquid securities in well-developed markets. Funds in this class would exhibit long-term volatility comparable to that of the S&P500. These funds should usually have a long-term volatility in the range of 13% – 18%.

6) **Diversified International Equity.** This class is similar to the Diversified Equity class, except that the majority of fund holdings are in foreign securities. This class should usually have a long-term volatility in the range of 14% – 19%.

7) **Intermediate Risk Equity.** This class has a mix of characteristics from both the Diversified and Aggressive Equity Classes. This class has a long-term volatility in the range of 19% – 25%.

8) **Aggressive or Exotic Equity.** This class comprises more volatile funds where risk can arise from: underdeveloped markets, uncertain markets, high volatility of returns, narrow focus (e.g., specific market sector), etc. This class (or market benchmark) either does not have sufficient history to allow for the calculation of a long-term expected volatility, or the volatility is very high. This class would be used whenever the long-term expected annualized volatility is indeterminable or exceeds 25%.

C) Selecting Appropriate Investment Classes. The selection of an appropriate investment type should be done at the level for which the guarantee applies. For guarantees applying on a deposit-by-deposit basis, the fund selection is straightforward. However, where the guarantee applies across deposits or for an entire contract, the approach can be more complicated. In such instances, the approach is to identify for each contract where the “grouped holdings” fit within the categories listed and to classify the associated assets on this basis.

A seriatim process is used to identify the “grouped” fund holdings, to assess the risk profile of the current fund holdings (possibly calculating the expected long-term volatility of the funds held with reference to the indicated market proxies), and to classify the entire ‘asset exposure’ into one of the specified choices. Here, ‘asset exposure’ refers to the underlying assets (separate and/or general account investment options) on which the guarantee will be determined. For example, if the guarantee applies separately for each deposit year within the contract, then the classification process would be applied separately for the exposure of each deposit year.

In summary, mapping the benefit exposure (i.e., the asset exposure that applies to the calculation of the guaranteed minimum death benefits) to one of the prescribed asset classes is a multi-step process:

1) Map each separate and/or general account investment option to one of the prescribed asset classes. For some funds, this mapping will be obvious, but for others it will involve a review of the fund’s investment policy, performance benchmarks, composition and expected long-term volatility.

2) Combine the mapped exposure to determine the expected long-term “volatility of current fund holdings.” This will require a calculation based on the expected long-term volatility for each fund and the correlations between the prescribed asset classes as given in the table “Correlation Matrix for Prescribed Asset Classes,” in section A4.4)D).
3) Evaluate the asset composition and expected volatility (as calculated in step 2) of current holdings to determine the single asset class that best represents the exposure, with due consideration to the constraints and guidelines presented earlier in this section.

In step 1, the company should use the fund’s actual experience (i.e., historical performance, inclusive of reinvestment) only as a guide in determining the expected long-term volatility. Due to limited data and changes in investment objectives, style and/or management (e.g., fund mergers, revised investment policy, different fund managers, etc.); the company may need to give more weight to the expected long-term volatility of the fund’s benchmarks. In general, the company should exercise caution and not be overly optimistic in assuming that future returns will consistently be less volatile than the underlying markets.

In step 2, the company should calculate the “volatility of current fund holdings” (for the exposure being categorized) by the following formula

$$\sigma = \sqrt{\sum_{i} \sum_{j} w_i w_j \rho_{ij} \sigma_i \sigma_j}$$

using the volatilities and correlations in the following table where $w_i = \frac{AV_i}{\sum_k AV_k}$ is the relative value of fund i expressed as a proportion of total contract value, $\rho_{ij}$ is the correlation between asset classes i and j and $\sigma_i$ is the volatility of asset class i. An example is provided after the table.
D) Correlation Matrix for Prescribed Asset Classes.

<table>
<thead>
<tr>
<th>ANNUAL VOLATILITY</th>
<th>FIXED ACCOUNT</th>
<th>MONEY MARKET</th>
<th>FIXED INCOME</th>
<th>BALANCED</th>
<th>DIVERSE EQUITY</th>
<th>INTL EQUITY</th>
<th>INTERM EQUITY</th>
<th>AGGR EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.0% FIXED ACCOUNT</td>
<td>1</td>
<td>0.50</td>
<td>0.15</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1.5% MONEY MARKET</td>
<td>0.50</td>
<td>1</td>
<td>0.20</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>5.0% FIXED INCOME</td>
<td>0.15</td>
<td>0.20</td>
<td>1</td>
<td>0.30</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
<td>0.05</td>
</tr>
<tr>
<td>10.0% BALANCED</td>
<td>0</td>
<td>0</td>
<td>0.30</td>
<td>1</td>
<td>0.95</td>
<td>0.60</td>
<td>0.75</td>
<td>0.60</td>
</tr>
<tr>
<td>15.5% DIVERSE EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.10</td>
<td>0.95</td>
<td>1</td>
<td>0.60</td>
<td>0.80</td>
<td>0.70</td>
</tr>
<tr>
<td>17.5% INTL EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.10</td>
<td>0.60</td>
<td>0.60</td>
<td>1</td>
<td>0.50</td>
<td>0.60</td>
</tr>
<tr>
<td>21.5% INTERM EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.10</td>
<td>0.75</td>
<td>0.80</td>
<td>0.50</td>
<td>1</td>
<td>0.70</td>
</tr>
<tr>
<td>26.0% AGGR EQUITY</td>
<td>0</td>
<td>0</td>
<td>0.05</td>
<td>0.60</td>
<td>0.70</td>
<td>0.60</td>
<td>0.70</td>
<td>1</td>
</tr>
</tbody>
</table>

E) Fund Categorization Example. As an example, suppose three funds (Fixed Income, diversified U.S. Equity and Aggressive Equity) are offered to clients on a product with a contract level guarantee (i.e., across all funds held within the contract). The current fund holdings (in dollars) for five sample contracts are shown in the following table.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>MV Fund X (Fixed Income):</td>
<td>5,000</td>
<td>4,000</td>
<td>8,000</td>
<td>-</td>
<td>5,000</td>
</tr>
<tr>
<td>MV Fund Y (Diversified Equity):</td>
<td>9,000</td>
<td>7,000</td>
<td>2,000</td>
<td>6,000</td>
<td>-</td>
</tr>
<tr>
<td>MV Fund Z (Aggressive Equity):</td>
<td>1,000</td>
<td>4,000</td>
<td>-</td>
<td>4,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total Market Value:</td>
<td>15,000</td>
<td>15,000</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Total Equity Market Value:</td>
<td>10,000</td>
<td>11,000</td>
<td>2,000</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Fixed Income % (A):</td>
<td>33%</td>
<td>27%</td>
<td>80%</td>
<td>0%</td>
<td>50%</td>
</tr>
<tr>
<td>Fixed Income Test (A&gt;75%):</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Aggressive % of Equity (B):</td>
<td>10%</td>
<td>36%</td>
<td>n/a</td>
<td>40%</td>
<td>100%</td>
</tr>
<tr>
<td>Balanced Test (A&gt;25% &amp; B&lt;33.3%):</td>
<td>Yes</td>
<td>No</td>
<td>n/a</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Volatility of Current Fund Holdings:</td>
<td>10.9%</td>
<td>13.2%</td>
<td>5.3%</td>
<td>19.2%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Fund Classification:</td>
<td>Balanced</td>
<td>Diversified*23</td>
<td>Fixed Income</td>
<td>Intermediate</td>
<td>Diversified</td>
</tr>
</tbody>
</table>

*23 Although the volatility suggests “Balanced Fund,” the Balanced Fund criteria were not met. Therefore, this “exposure” is moved “up” to Diversified Equity. For those funds classified as Diversified Equity, additional analysis would be required to assess whether they should be instead designated as “Diversified International Equity.”
As an example, the "Volatility of Current Fund Holdings" for contract #1 is calculated as $\sqrt{A+B}$ where:

$$A = \left( \frac{5}{15} \right)^2 + \left( \frac{9}{15} \times 0.155 \right)^2 + \left( \frac{1}{15} \times 0.26 \right)^2$$

$$B = 2 \left( \frac{5}{15} \times 0.05 \times 0.155 \right) + 2 \left( \frac{1}{15} \times 0.05 \times 0.26 \right) + 2 \left( \frac{9}{15} \times 0.7 \times 0.155 \times 0.26 \right)$$

So the volatility for contract #1 = $\sqrt{0.0092 + 0.0026} = 0.109$ or 10.9%.

### A4.5) Tables

A) Liability Modeling Assumptions & Product Characteristics used for GC Factors.

<table>
<thead>
<tr>
<th>Asset Based Charges (MER)</th>
<th>Vary by fund class. See section A4.5(B).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Margin Offset</td>
<td>100 basis points per annum.</td>
</tr>
</tbody>
</table>

**GMDB Description**

1. ROP = return of premium ROP.
2. ROLL3 = 3% roll-up, capped at 2.5 x premium, frozen at age 80.
3. ROLL5 = 5% roll-up, capped at 2.5 x premium, frozen at age 80.
4. MAV = annual ratchet (maximum anniversary value), frozen at age 80.
5. HIGH = Higher of 5% roll-up and annual ratchet.
6. EDB = 40% Enhanced Death Benefit (capped at 40% of deposit). Note that the Pre-Calculated Factors were originally calculated with a combined ROP benefit, but they have been adjusted to remove the effect of the ROP. Thus, the factors for this benefit 5 are solely for the Enhanced Death Benefit.

**Adjustment to GMDB Upon Partial Withdrawal**

Separate factors for “Pro-Rata by Market Value” and “Dollar-for-Dollar.”

**Surrender Charges**

Ignored (i.e., zero). Included in the CA component.

**Single Premium / Deposit**

$100,000. No future deposits; no intra-contract fund rebalancing.

**Base Contract Lapse Rate (Total Surrenders)**

- Pro-rata by MV: 10% p.a. at all contract durations (before dynamics)
- Dollar-for-dollar: 2% p.a. at all contract durations (no dynamics)

**Partial Withdrawals**

- Pro-rata by MV: None (i.e., zero)
- Dollar-for-dollar: Flat 8% p.a. at all contract durations (as a % of AV). No dynamics or anti-selective behavior.

**Mortality**

100% of the 1994 Variable Annuity MGDB Mortality Table (MGDB 94 ALB). For reference, $1000 \times q_x$ rates at ages 65 and 70 for 100% of MGDB 94 ALB Male are 18.191 and 29.363 respectively. Note that section A4.3(I) allows modification to this assumption.

**Gender / Age Distribution**

100% male. Methodology accommodates different attained ages. A 5-year age setback will be used for female annuitants.

**Max. Annuitzation Age**

All policies terminate at age 95.

**Fixed Expenses**

Ignored (i.e., zero). Included in the FE component.

**Annual Fee and Waiver**

Ignored (i.e., zero). Included in the FE component.
Discount Rate 5.75% pre-tax.

Dynamic Lapse Multiplier
(Appplies only to policies where GMDB is adjusted “pro-rata by MV” upon withdrawal)

\[ \lambda = \text{MIN} \left[ U, \text{MAX} \left[ L, 1 - M \times \left( \frac{GV}{AV} - D \right) \right] \right] \]

\[ U=1, L=0.5, M=1.25, D=1.1 \]
- Applied to the ‘Base Contract Lapse Rate’
- Does not apply to partial withdrawals.

B) Asset-Based Fund Charges (bps per annum).

<table>
<thead>
<tr>
<th>Asset Class / Fund</th>
<th>Account Value Charge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Account</td>
<td>0</td>
</tr>
<tr>
<td>Money Market</td>
<td>110</td>
</tr>
<tr>
<td>Fixed Income (Bond)</td>
<td>200</td>
</tr>
<tr>
<td>Balanced</td>
<td>250</td>
</tr>
<tr>
<td>Diversified Equity</td>
<td>250</td>
</tr>
<tr>
<td>Diversified International Equity</td>
<td>250</td>
</tr>
<tr>
<td>Intermediate Risk Equity</td>
<td>265</td>
</tr>
<tr>
<td>Aggressive or Exotic Equity</td>
<td>275</td>
</tr>
</tbody>
</table>

C) Components of Key Used for GC Factor Look-Up.

(First Digit Always “1”)

<table>
<thead>
<tr>
<th>Contract Attribute</th>
<th>Key : Possible Values &amp; Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Definition, P</td>
<td>0 : 0 Return-of-premium.</td>
</tr>
<tr>
<td></td>
<td>1 : 1 Roll-up (3% per annum).</td>
</tr>
<tr>
<td></td>
<td>2 : 2 Roll-up (5% per annum).</td>
</tr>
<tr>
<td></td>
<td>3 : 3 Maximum Anniversary Value (MAV).</td>
</tr>
<tr>
<td></td>
<td>4 : 4 High of MAV and 5% Roll-up.</td>
</tr>
<tr>
<td></td>
<td>5 : 5 Enhanced Death Benefit (excludes the ROP GMDB, which would have to be added separately if the contract in question has an ROP benefit.)</td>
</tr>
<tr>
<td>GV Adjustment Upon Partial Withdrawal, A</td>
<td>0 : 0 Pro-rata by market value.</td>
</tr>
<tr>
<td></td>
<td>1 : 1 Dollar-for-dollar.</td>
</tr>
<tr>
<td>Fund Class, F</td>
<td>0 : 0 Fixed Account.</td>
</tr>
<tr>
<td></td>
<td>1 : 1 Money Market.</td>
</tr>
<tr>
<td></td>
<td>2 : 2 Fixed Income (Bond).</td>
</tr>
<tr>
<td></td>
<td>3 : 3 Balanced Asset Allocation.</td>
</tr>
<tr>
<td></td>
<td>4 : 4 Diversified Equity.</td>
</tr>
<tr>
<td></td>
<td>5 : 5 International Equity.</td>
</tr>
<tr>
<td></td>
<td>6 : 6 Intermediate Risk Equity.</td>
</tr>
<tr>
<td></td>
<td>7 : 7 Aggressive / Exotic Equity.</td>
</tr>
<tr>
<td>Attained Age (Last Birthday), X</td>
<td>0 : 35</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>--------</td>
</tr>
<tr>
<td></td>
<td>1 : 45</td>
</tr>
<tr>
<td></td>
<td>2 : 55</td>
</tr>
<tr>
<td></td>
<td>3 : 60</td>
</tr>
<tr>
<td>Contract Duration (years-since-issue), D</td>
<td>0 : 0.5</td>
</tr>
<tr>
<td></td>
<td>2 : 6.5</td>
</tr>
<tr>
<td></td>
<td>4 : 12.5</td>
</tr>
<tr>
<td>Account Value-to-Guaranteed Value Ratio, φ</td>
<td>0 : 0.25</td>
</tr>
<tr>
<td></td>
<td>1 : 0.50</td>
</tr>
<tr>
<td></td>
<td>2 : 0.75</td>
</tr>
<tr>
<td></td>
<td>3 : 1.00</td>
</tr>
<tr>
<td>Annualized Account Charge Differential from A4.5B) Assumptions</td>
<td>0 : −100 bps</td>
</tr>
<tr>
<td></td>
<td>1 : +0</td>
</tr>
<tr>
<td></td>
<td>2 : +100</td>
</tr>
</tbody>
</table>
APPENDIX 5 - Scenario Calibration Criteria

A5.1) General

This Appendix outlines the requirements for the stochastic models used to simulate fund performance. Specifically, it sets certain standards that must be satisfied and offers guidance to the actuary in the development and validation of the scenario models. Background material and analysis are presented to support the recommendation. The Appendix focuses on the S&P 500 as a proxy for returns on a broadly diversified U.S. equity fund, but there is also advice on how the techniques and requirements would apply to other types of funds. General modeling considerations such as the number of scenarios and projection frequency are also discussed.

The calibration points given in this Appendix are applicable to gross returns (before the deduction of any fees or charges). To determine the net returns appropriate for the projections required by the Guideline, the actuary shall reflect applicable fees and contractholder charges in the development of projected account values. The projections shall also include the costs of managing the investments and converting the assets into cash when necessary.

As a general rule, funds with higher expected returns should have higher expected volatilities and in the absence of well-documented mitigating factors (e.g., a highly reliable and favorable correlation to other fund returns), should lead to higher reserve requirements.

State or path dependent models are not prohibited, but must be justified by the historic data and meet the calibration criteria. To the degree that the model uses mean-reversion or path-dependent dynamics, this must be well supported by research and clearly documented in the Memorandum supporting the required actuarial certification.

The equity scenarios used to determine reserves must be available in an electronic format to facilitate any regulatory review.

A5.2) Gross Wealth Ratios

Gross Wealth Ratios derived from the stochastic return scenarios for use with a Separate Account variable fund category for diversified U.S. equities must satisfy calibration criteria consistent with that for the S&P 500 shown in the following table. Under these calibration criteria, Gross Wealth Ratios for quantiles less than 50 percent may not exceed the value from the table corresponding to the quantile, while at quantiles greater than 50 percent; Gross Wealth Ratios may not be less than the corresponding value for the quantile from the table. Gross Wealth Ratios must be tested for holding period 1, 5, 10 and 20 years throughout the projections, except as noted in section A5.3).

The “wealth factors” are defined as gross accumulated values (i.e., before the deduction of fees and charges) with complete reinvestment of income and maturities, starting with a unit investment. These can be less than 1, with “1” meaning a zero return over the holding period.

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24 For more details on the development of these requirements, including the development of the calibration points, see the American Academy of Actuaries recommendation on C-3 Phase II risk-based capital.

25 While the model need not strictly adhere to ‘mean-variance efficiency,’ prudence dictates some form of consistent risk/return relationship between the proxy investment funds. In general, it would be inappropriate to assume consistently ‘superior’ expected returns (i.e., risk/return point above the frontier).
S&P 500 Total Return Gross Wealth Ratios at the Calibration Points

<table>
<thead>
<tr>
<th>Calibration Point</th>
<th>One Year</th>
<th>Five Year</th>
<th>Ten Year</th>
<th>Twenty Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.5%</td>
<td>0.78</td>
<td>0.72</td>
<td>0.79</td>
<td></td>
</tr>
<tr>
<td>5.0%</td>
<td>0.84</td>
<td>0.81</td>
<td>0.94</td>
<td>1.51</td>
</tr>
<tr>
<td>10.0%</td>
<td>0.90</td>
<td>0.94</td>
<td>1.16</td>
<td>2.10</td>
</tr>
<tr>
<td>90.0%</td>
<td>1.28</td>
<td>2.17</td>
<td>3.63</td>
<td>9.02</td>
</tr>
<tr>
<td>95.0%</td>
<td>1.35</td>
<td>2.45</td>
<td>4.36</td>
<td>11.70</td>
</tr>
<tr>
<td>97.5%</td>
<td>1.42</td>
<td>2.72</td>
<td>5.12</td>
<td></td>
</tr>
</tbody>
</table>

The scenarios need not strictly satisfy all calibration points, but the actuary should be satisfied that any differences do not materially reduce the resulting reserves.\(^{26}\) In particular, the actuary should be mindful of which tail most affects the business being valued. If reserves are less dependent on the right (left) tail for all products under consideration (e.g., a return of premium guarantee would primarily depend on the left tail, an enhanced death benefit equal to a percentage of the gain would be most sensitive to the right tail, etc.), it is not necessary to meet the right (left) calibration points.

For models that require starting values for certain state variables,\(^{27}\) long-term (‘average’ or ‘neutral’) values should be used for calibration. The same values should normally be used to initialize the models for generating the actual projection scenarios unless an alternative assumption can be clearly justified.\(^{28}\) It should be noted that a different set of initialization parameters might produce scenarios that do not satisfy all the calibration points shown in the above table. However, the S&P 500 scenarios used to determine reserves must meet the calibration criteria.

### A5.3) Calibration Requirements Beyond Twenty Years

It is possible to parameterize some path and/or state dependent models to produce higher volatility (and/or lower expected returns) in the first 20 years in order to meet the calibration criteria, but with lower volatility (and/or higher expected returns) for other periods during the forecast horizon. While this property may occur for certain scenarios (e.g., the state variables would evolve over the course of the projection and thereby affect future returns), it would be inappropriate and unacceptable for a company to alter the model parameters and/or its characteristics for periods beyond year 20 in a fashion not contemplated at the start of the projection and primarily for the purpose(s) of reducing the volatility and/or severity of ultimate returns.\(^{29}\)

### A5.4) Other Funds

Calibration of other markets (funds) is left to the judgment of the actuary, but the scenarios so generated must be consistent with the calibration points in the table in section A5.2). This does not imply a strict functional relationship between the model parameters for various markets/funds, but it would generally be inappropriate to assume that a market or fund consistently “outperforms” (lower risk, higher expected return relative to the efficient frontier) over the long term.

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\(^{26}\) See the Preamble to the Accounting Practices and Procedures Manual for an explanation of materiality.

\(^{27}\) For example, a stochastic log volatility (“SLV”) model requires the starting volatility. Also, the regime-switching lognormal model requires an assumption about the starting regime.

\(^{28}\) A clear justification exists when state variables are observable or “known” to a high degree of certainty and not merely estimated or inferred based on a “balance of probabilities.”

\(^{29}\) Such adjustments must be clearly documented and justified by the historic data.
The actuary shall document the actual 1-, 5-, 10- and 20-year wealth factors of the scenarios at the same frequencies as in the “S&P 500 Total Return Gross Wealth Ratios at the Calibration Points” table in section A5.2). The annualized mean and standard deviation of the wealth factors for the 1-, 5-, 10- and 20-year holding periods must also be provided. For equity funds, the actuary shall explain the reasonableness of any significant differences from the S&P500 calibration points.

When parameters are fit to historic data without consideration of the economic setting in which the historic data emerged, the market price of risk may not be consistent with a reasonable long-term model of market equilibrium. One possibility for establishing ‘consistent’ parameters (or scenarios) across all funds would be to assume that the market price of risk is constant (or nearly constant) and governed by some functional (e.g., linear) relationship. That is, higher expected returns can only be garnered by assuming greater risk.30

Specifically, two return distributions $X$ and $Y$ would satisfy the following relationship:

$$
\text{Market Price of Risk} = \left( \frac{E[R_X] - r}{\sigma_X} \right) = \left( \frac{E[R_Y] - r}{\sigma_Y} \right)
$$

where $E[R]$ and $\sigma$ are respectively the (unconditional) expected returns and volatilities and $r$ is the expected risk-free rate over a suitably long holding period commensurate with the projection horizon. One approach to establish consistent scenarios would set the model parameters to maintain a near-constant market price of risk.

A closely related method would assume some form of ‘mean-variance’ efficiency to establish consistent model parameters. Using the historic data, the mean-variance (alternatively, ‘drift-volatility’) frontier could be a constructed from a plot of (mean, variance) pairs from a collection of world market indices. The frontier could be assumed to follow some functional form,31 with the coefficients determined by standard curve fitting or regression techniques. Recognizing the uncertainty in the data, a ‘corridor’ could be established for the frontier. Model parameters would then be adjusted to move the proxy market (fund) inside the corridor.

Clearly, there are many other techniques that could be used to establishing consistency between the scenarios. While appealing, the above approaches do have drawbacks32 and the actuary should not be overly optimistic in constructing the model parameters or the scenarios.

Funds can be grouped and projected as a single fund if such grouping is not anticipated to materially reduce reserves. However, care should be taken to avoid exaggerating the benefits of diversification. The actuary must document the development of the investment return scenarios and be able to justify the mapping of the company’s variable accounts to the proxy funds used in the modeling.

### A5.5) Correlation of Fund Returns

In constructing the scenarios for the proxy funds, the company may require parameter estimates for a number of different market indices. When more than one index is projected, it is generally necessary to allow for correlations in the simulations. It is not necessary to assume that all markets are perfectly positively correlated, but an assumption of independence (zero correlation) between the equity markets would inappropriately exaggerate the benefits of diversification. An examination of the historic data suggests that correlations are not stationary and that they tend to increase during times of high volatility.

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30 As an example, the standard deviation of log returns is often used as a measure of risk.
31 Quadratic polynomials and logarithmic functions tend to work well.
32 For example, mean-variance measures ignore the asymmetric and fat-tailed profile of most equity market returns.
or negative returns. As such, the actuary should take care not to underestimate the correlations in those scenarios used for the reserve calculations.

If the projections include the simulation of interest rates (other than for discounting surplus strain) as well as equity returns, the processes may be independent provided that the actuary can demonstrate that this assumption (i.e., zero correlation) does not materially underestimate the resulting reserves.

A5.6) Number of Scenarios and Efficiency in Estimation

For straight Monte Carlo simulation (with equally probable “paths” of fund returns), the number of scenarios should typically equal or exceed 1000. The appropriate number will depend on how the scenarios will be used and the materiality of the results. The actuary should use a number of scenarios that will provide an acceptable level of precision.

Fewer than 1000 scenarios may be used provided that the actuary has determined through prior testing (perhaps on a subset of the portfolio) that the CTE values so obtained materially reproduce the results from running a larger scenario set.

Variance reduction and other sampling techniques are intended to improve the accuracy of an estimate more efficiently than simply increasing the number of simulations. Such methods can be used provided the actuary can demonstrate that they do not lead to a material understatement of results. Many of the techniques are specifically designed for estimating means, not tail measures, and could in fact reduce accuracy (and efficiency) relative to straight Monte Carlo simulation.33

The above requirements and warnings are not meant to preclude or discourage the use of valid and appropriate sampling methods, such as Quasi Random Monte Carlo (QRMC), importance sampling or other techniques designed to improve the efficiency of the simulations (relative to pseudo-random Monte Carlo methods). However, the actuary should maintain documentation that adequately describes any such techniques used in the projections. Specifically, the documentation should include the reasons why such methods can be expected not to result in systematic or material under-estimate of the resulting reserves compared to using pseudo-random Monte Carlo numbers.

A5.7) Frequency of Projection and Time Horizon

Use of an annual cashflow frequency (“timestep”) is generally acceptable for benefits/features that are not sensitive to projection frequency. The lack of sensitivity to projection frequency should be validated by testing wherein the actuary should determine that the use of a more frequent (i.e., shorter) time step does not materially increase reserves. A more frequent time increment should always be used when the product features are sensitive to projection period frequency.

Care must be taken in simulating fee income and expenses when using an annual time step. For example, recognizing fee income at the end of each period after market movements, but prior to persistency decrements, would normally be an inappropriate assumption. It is also important that the frequency of the investment return model be linked appropriately to the projection horizon in the liability model. In particular, the horizon should be sufficiently long so as to capture the vast majority of costs (on a present value basis) from the scenarios.34

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33 However, with careful implementation, many variance reduction techniques can work well for CTE estimators. For example, see Manistre, B.J. and Hancock, G. (2003), “Variance of the CTE Estimator,” 2003 Stochastic Modeling Symposium, Toronto, ON, September 2003.

34 As a general guide, the forecast horizon should not be less than 20 years.
A5.8) Pre-Packaged Scenarios

The American Academy of Actuaries has provided 10,000 scenarios on its website for the following nineteen asset classes.36

1) 3-month U.S. Treasury yields
2) 6-month U.S. Treasury yields
3) 1-year U.S. Treasury yields
4) 2-year U.S. Treasury yields
5) 3-year U.S. Treasury yields
6) 5-year U.S. Treasury yields
7) 7-year U.S. Treasury yields
8) 10-year U.S. Treasury yields
9) 20-year U.S. Treasury yields
10) 30-year U.S. Treasury yields
11) Money Market / Short-Term
12) U.S. Intermediate Term Government Bonds
13) U.S. Long Term Corporate Bonds
14) Diversified Fixed Income
15) Diversified Balanced Allocation
16) Diversified Large Capitalized U.S. Equity
17) Diversified International Equity
18) Intermediate Risk Equity
19) Aggressive or Specialized Equity

The scenarios are available as gross monthly accumulation factors (or U.S. Treasury yields) over a 30-year horizon in comma-separated value format (*.csv). These scenarios have been appropriately

35 The pre-packaged scenarios can be found at http://www.actuary.org/life/phase2.asp and are fully documented at http://www.actuary.org/pdf/life/c3supp_march05.pdf.
36 Because the reserves calculated using projections involve cash flow projections, the pre-packaged scenarios were developed under the “real world” probability measure (as opposed to a “risk-neutral” basis). Therefore, the pre-packaged scenarios may not be appropriate for purposes of projecting the market value of future hedge instruments within a projection (to the extent such instruments are used in the projections). For this purpose, it may be more appropriate to use risk neutral scenarios to determine the market value of hedge instruments in the cash flow projections that are based on real world scenarios.
correlated so that the $K^{th}$ scenario for each asset class must be used together and considered one ‘future investment return scenario.’ Hence, the scenarios can be combined (by blending the accumulation factors) to create additional ‘proxy’ scenarios for the company’s funds.

For example, suppose the actuary wanted to construct scenarios for a ‘balanced fund’ that targets a 60/40 allocation between bonds and U.S. equities. If we denote $[\text{AF}^X]$ as the matrix of accumulation factors for asset class X, then the balanced scenarios would be defined by $[\text{AF}^{\text{BAL}}] = 0.60 \times [\text{AF}^{\text{BOND}}] + 0.40 \times [\text{AF}^{\text{S&P500}}]$. Care should be taken to avoid exaggerating the benefits of diversification. The actuary shall document the development of the investment return scenarios and be able to justify the mapping of the company’s variable accounts to the proxy funds used in the modeling.

The U.S. Treasury yields are expressed as nominal semi-annual bond equivalent yields in decimal format. All other returns are expressed as periodic (not cumulative) market accumulation factors (i.e., monthly “gross wealth ratios”). Interest rates are assumed to change at the start of each month, hence the value in column T applies for month T-1. The market accumulation factor in column T represents the growth in month T-1.

If all or a portion of these scenarios are used, then the actuary shall verify that the scenario calibration criteria are met.

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37 It is inappropriate to misalign the ordering of scenarios (e.g., scenario J for “Diversified U.S. Equity” cannot be combined with scenario K for “Diversified International Equity,” where $J \neq K$).

38 It is important to blend the accumulation factors (not the returns) in order to achieve the desired asset mix.
APPENDIX 6 - Allocation of the Aggregate Reserves to the Contract Level

Section IV states that the Aggregate Reserve shall be allocated to the contracts falling within the scope of the Guideline. When the Conditional Tail Expectation Amount is greater than the Standard Scenario Amount, this allocation requires that the excess be allocated to the contracts falling within the scope of the Guideline.

A6.1) Allocation when the Aggregate Reserve equals the Conditional Tail Expectation Amount

A) Single sub-grouping. When the Aggregate Reserve is equal to the Conditional Tail Expectation Amount and the Conditional Tail Expectation Amount is determined in aggregate for all contracts falling within the scope of the Guideline (i.e., a single grouping), as described in Section IV)D), the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount shall be allocated to each contract on the basis of the difference between the Standard Scenario Reserve and the Cash Surrender Value\(^{39}\) on the valuation date for the contract. If the cash surrender value is not defined or not available, the Standard Scenario Amount will be the basis of allocation.

B) Multiple sub-groupings. When the Aggregate Reserve is equal to the Conditional Tail Expectation Amount and the Conditional Tail Expectation Amount is determined using more than one sub-grouping, as described in Section IV)D), the allocation of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount shall reflect that sub-grouping of contracts used to determine the Conditional Tail Expectation Amount, as described in Section IV)D).

For example, when the Conditional Tail Expectation Amount is determined using sub-grouping, the excess of the aggregate (i.e., the total for all contracts within the scope of the Guideline) Conditional Tail Expectation Amount over the aggregate Standard Scenario Amount shall be allocated only to those contracts that are part of sub-groupings whose contributions to the Conditional Tail Expectation Amount exceed their contribution to the Standard Scenario Amount.

In the case of such sub-groupings, the excess of the aggregate Conditional Tail Expectation Amount over the aggregate Standard Scenario Amount shall be allocated to each sub-grouping in proportion to the difference between the Conditional Tail Expectation and the Standard Scenario Reserve for each sub-grouping for which that excess is positive.

Once the allocation to each sub-grouping is determined, the excess of the reserve allocated to such sub-grouping over the Standard Scenario Amount determined for that sub-grouping shall be allocated to each contract within that sub-grouping on the basis of the difference between the Standard Scenario Reserve and the Cash Surrender Value on the valuation date for the contracts. If the cash surrender value is not defined or not available, the Standard Scenario Amount will be the basis of allocation.

\(^{39}\) Note that since the Standard Scenario Reserve for a contract is, by definition, greater than or equal to the Cash Surrender Value, it is understood that the difference between the Standard Scenario Reserve and the Cash Surrender Value for each contract will never be less than zero.
As an example, consider a company with the results of the following three sub-groupings:

<table>
<thead>
<tr>
<th>Sub-grouping</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conditional Tail Expectation Amount</td>
<td>28</td>
<td>40</td>
<td>52</td>
<td>120</td>
</tr>
<tr>
<td>Standard Scenario Amount</td>
<td>20</td>
<td>45</td>
<td>30</td>
<td>95</td>
</tr>
<tr>
<td><strong>Aggregate Reserve</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>120</strong></td>
</tr>
<tr>
<td>(1) – (2)</td>
<td>8</td>
<td>-5</td>
<td>22</td>
<td>25</td>
</tr>
<tr>
<td>Allocation</td>
<td>6.67</td>
<td>0</td>
<td>18.33</td>
<td>25</td>
</tr>
</tbody>
</table>

In this example, the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount, in aggregate, equals 25 (i.e., the “Total” column of row 1 less row 2, or 120 – 95). This excess of 25 would be allocated only to those contracts that are part of sub-groupings whose contributions to the Conditional Tail Expectation Amount exceed their contributions to the Standard Scenario Amount. In this example, that would be contracts in sub-groupings A and C (since in sub-grouping B, the contribution to the Standard Scenario Amount exceeds the contribution to the Conditional Tail Expectation Amount). Therefore, the excess of 25 would be allocated to the contracts in sub-groupings A and C in proportion to the difference between the Conditional Tail Expectation Amount and the Standard Scenario Reserve for those sub-groupings (i.e. row 4). In this example, the total difference between the Conditional Tail Expectation Amount and the Standard Scenario Reserve for the contracts in sub-groupings A and C equals 8 + 22, or 30. This would result in 8/30 of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount (or 6.67) to be allocated to the contracts in sub-groupings A and 22/30 of the excess of the Conditional Tail Expectation Amount over the Standard Scenario Amount (or 18.33) to be allocated to the contracts in sub-groupings C as shown on line (5) above.

In this example, the allocation of the Aggregate Reserve to contracts within sub-grouping B would equal the Standard Scenario Reserve for those contracts (as described in section A6.2) below). For sub-groupings A and C, the difference between the allocation of the Aggregate Reserve to each of those sub-grouping and the Standard Scenario Amount determined for each of those sub-grouping would be allocated to each contract within each of those sub-groupings based on the difference between the Standard Scenario Reserve and the Cash Surrender Value for each of the contracts within the relevant sub-group. The result would be an allocated Aggregate Reserve for a given contract that would be equal to the Standard Scenario Reserve for that contract plus the amount of the difference between 1) and 2) below that is allocated to that contract, where:

1)  Equals the allocation of the Aggregate Reserve to that contract’s sub-grouping; and

2)  Equals the Standard Scenario Amount determined for that contract’s sub-grouping.

**A6.2) Allocation when the Aggregate Reserve equals the Standard Scenario Amount**

The Standard Scenario Amount, as required by Section IV)C), is calculated on a contract-by-contract basis, as described in Appendix 3. Therefore, when the Aggregate Reserve is equal to the Standard Scenario Amount, the reserve allocated to each contract shall be the reserve calculated for each contract under the Standard Scenario method.
APPENDIX 7 – Modeling of Hedges

A7.1) Initial Considerations

The appropriate costs and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline (excluding those that involve the offsetting of the risks associated with variable annuity guarantees with other products outside of the scope of the Guideline, such as equity-indexed annuities) shall be included in the calculation of the Conditional Tail Expectation Amount, determined in accordance with Section IV)(D) and section A1.4) of the Guideline (i.e., Conditional Tail Expectation Amount using projections). If the company is following a Clearly Defined Hedging Strategy (“hedging strategy”), as defined in Section III, in accordance with an investment policy adopted by the Board of Directors, or a committee of Board members, the company is eligible to reduce the amount of the Conditional Tail Expectation Amount using projections otherwise calculated. The investment policy must clearly articulate the company’s hedging objectives, including the metrics that drive rebalancing/trading. This specification could include maximum tolerable values for investment losses, earnings, volatility, exposure, etc. in either absolute or relative terms over one or more investment horizons vis-à-vis the chance of occurrence. Company management is responsible for developing, documenting, executing and evaluating the investment strategy, including the hedging strategy, used to implement the investment policy.

For this purpose, the investment assets refer to all the assets including derivatives supporting covered products and guarantees. This is also referred to as the investment portfolio. The investment strategy is the set of all asset holdings at all points in time in all scenarios. The hedging portfolio, which is also referred to as the hedging assets, is a subset of the investment assets. The hedging strategy is the hedging asset holdings at all points in time in all scenarios. There is no attempt to distinguish what is the hedging portfolio and what is the investment portfolio in this Appendix. Nor is the distinction between investment strategy and hedging strategy formally made here. Where necessary to give effect to the intent of this Appendix, the requirements applicable to the hedging portfolio or the hedging strategy are to apply to the overall investment portfolio and investment strategy.

This particularly applies to restrictions on the reasonableness or acceptability of the models that make up the stochastic cash flow model used to perform the projections, since these restrictions are inherently restrictions on the joint modeling of the hedging and non-hedging portfolio. To give effect to these requirements, they must apply to the overall investment strategy and investment portfolio.

The cost and benefits of hedging instruments that are currently held by the company in support of the contracts falling under the scope of the Guideline shall be included in the stochastic cash flow model used to calculate the Conditional Tail Expectation Amount in accordance with Section IV)(D) (the “model”). If the company is following a Clearly Defined Hedging Strategy, the model shall take into account the cost and benefits of hedge positions expected to be held by the company in the future based on the operation of the hedging strategy.

Before either a new or revised hedging strategy can be used to reduce the amount of the Conditional Tail Expectation Amount otherwise calculated, the hedging strategy should be in place (i.e., effectively implemented by the company) for at least three months. The company may meet the time requirement by having evaluated the effective implementation of the hedging strategy for at least three months without actually having executed the trades indicated by the hedging strategy (e.g., mock testing or by having effectively implemented the strategy with similar annuity products for at least three months).

These requirements do not supersede any statutes, laws, or regulations of any state or jurisdiction related to the use of derivative instruments for hedging purposes and should not be used in determining whether a company is permitted to use such instruments in any state or jurisdiction.
A7.2) Background

The analysis of the impact of the hedging strategy on cash flows is typically performed using either one of two methods as described below. Although a hedging strategy would normally be expected to reduce risk provisions, the nature of the hedging strategy and the costs to implement the strategy may result in an increase in the amount of the Conditional Tail Expectation Amount otherwise calculated.

The fundamental characteristic of the first method is that all hedging positions, both the currently held positions and those expected to be held in the future, are included in the stochastic cash flow model used to determine the Scenario Greatest Present Value, as discussed in Section IV)D), for each scenario. The fundamental characteristic of the second method is that the effectiveness of the current hedging strategy (including currently held hedge positions) on future cash flows is evaluated, in part or in whole, outside of the stochastic cash flow model. In this case, the reduction to the Conditional Tail Expectation Amount otherwise calculated should be commensurate with the degree of effectiveness of the hedging strategy in reducing accumulated deficiencies otherwise calculated.

Regardless of the methodology used by the company, the ultimate effect of the current hedging strategy (including currently held hedge positions), on the Conditional Tail Expectation Amount needs to recognize all risks, associated costs, imperfections in the hedges and hedging mismatch tolerances associated with the hedging strategy. The risks include, but are not limited to: basis, gap, price, parameter estimation, and variation in assumptions (mortality, persistency, withdrawal, annuitization, etc.). Costs include, but are not limited to: transaction, margin (opportunity costs associated with margin requirements) and administration. In addition, the reduction to the Conditional Tail Expectation Amount attributable to the hedging strategy may need to be limited due to the uncertainty associated with the company’s ability to implement the hedging strategy in a timely and effective manner. The level of operational uncertainty varies indirectly with the amount of time that the new or revised strategy has been in effect or mock tested.

No hedging strategy is perfect. A given hedging strategy may eliminate or reduce some but not all risks, transforms some risks into others, introduces new risks or has other imperfections. For example, a delta-only hedging strategy does not adequately hedge the risks measured by the “Greeks” other than delta. Another example is that financial indices underlying typical hedging instruments typically do not perform exactly like the separate account funds, and hence the use of hedging instruments has the potential for introducing basis risk.

A7.3) Calculation of CTE Amount(reported)

The company should begin by calculating “CTE Amount(best efforts)” – the results obtained when the Conditional Tail Expectation Amount (or “CTE Amount”) is based on incorporating the hedging strategy (including currently held hedge positions) into the stochastic cash flow model, including all of the factors and assumptions needed to execute the hedging strategy (e.g., stochastic implied volatility).

Because most models will include at least some approximations or idealistic assumptions, CTE Amount(best efforts) may overstate the impact of the hedging strategy. To compensate for potential overstatement of the impact of the hedging strategy, the company shall recalculate the Conditional Tail Expectation Amount assuming the company has no dynamic hedging strategy (i.e., reflect only hedge positions held by the company on the valuation date. The result so obtained is called “CTE Amount(adjusted).” In some situations the determination of CTE Amount(adjusted) may include both direct and indirect techniques.

Finally, the reported value for the Conditional Tail Expectation Amount is given by:

\[ \text{CTE Amount(reported)} = E \times \text{CTE Amount(best efforts)} + \]
(1 – E) × CTE Amount(adjusted)

The value for E (an “effectiveness factor”) reflects the actuary’s view as to the level of sophistication of the stochastic cash flow model and its ability to properly reflect the parameters of the hedging strategy (i.e., the “Greeks” being covered by the strategy) as well as the associated costs, risks, and benefits E will be no greater than 0.70. As the sophistication of the stochastic cash flow model increases, the value for E increases (i.e., the greater the ability of the CTE Amount(best efforts) model to capture all risks and uncertainties, the higher the value of E). If the model used to determine the “CTE Amount(best efforts)” effectively reflects all of the parameters used in the hedging strategy, the value of E may be up to 0.70. If certain economic risks are not hedged, yet the model does not generate scenarios that sufficiently capture those risks, E must be in the lower end of the range. If hedge cash flows are not modeled directly, E will be no greater than 0.30. Simplistic hedge cash flow models will have a value of E in the low range between 0.00 and 0.70.

Additionally, the company shall demonstrate that, based on an analysis of at least the most recent 12 months, the model is able to replicate the hedging strategy in a way that justifies the value used for E. A company that does not have 12 months of experience to date shall set E to a value no greater than 0.30.

A7.4) Specific Considerations and Requirements

As part of the process of choosing a methodology and assumptions for estimating the future effectiveness of the current hedging strategy (including currently held hedge positions) for purposes of reducing the Conditional Tail Expectation Amount, the actuary should review actual historical hedging effectiveness. The actuary shall evaluate the appropriateness of the assumptions on future trading, transaction costs, and other elements of the model, the strategy, the mix of business, and other items that are likely to result in materially adverse results. This includes an analysis of model assumptions that, when combined with the reliance on the hedging strategy, are likely to result in adverse results relative to those modeled. The parameters and assumptions shall be adjusted (based on testing contingent on the strategy used and other assumptions) to levels that fully reflect the risk based on historical ranges and foreseeable future ranges of the assumptions and parameters. If this is not possible by parameter adjustment, the model shall be modified to reflect them at either Anticipated Experience or adverse estimates of the parameters.

A discontinuous hedging strategy is a hedging strategy where the relationships between the sensitivities to equity markets and interest rates (commonly referred to as the Greeks) associated with the guaranteed contractholder options embedded in the variable annuities and other in-scope products and these same sensitivities associated with the hedging assets are subject to material discontinuities. This includes, but is not limited to, a hedging strategy where material hedging assets will be obtained when the variable annuity account balances reach a predetermined level in relationship to the guarantees. Any hedging strategy, including a delta hedging strategy, can be a discontinuous hedging strategy if implementation of the strategy permits material discontinuities between the sensitivities to equity markets and interest rates associated with the guaranteed contractholder options embedded in the variable annuities and other in-scope products and these same sensitivities associated with the hedging assets. There may be scenarios that are particularly costly to discontinuous hedging strategies, especially where those result in large discontinuous changes in sensitivities (Greeks) associated with the hedging assets. Where discontinuous hedging strategies contribute materially to a reduction in the Conditional Tail Expectation Amount, the actuary must evaluate the interaction of future trigger definitions and the discontinuous hedging strategy, in addition to the items mentioned in the previous paragraph. This includes an analysis of model assumptions that, when combined with the reliance on the discontinuous hedging strategy, may result in adverse results relative to those modeled.

Implementing a strategy that has a strong dependence on acquiring hedging assets at specific times that depend on specific values of an index or other market indicators may not be implemented as precisely as planned.
The combination of elements of the stochastic cash flow model, including the initial actual market asset prices, prices for trading at future dates, transaction costs, and other assumptions should be analyzed by the actuary as to whether the stochastic cash flow model permits hedging strategies that make money in some scenarios without losing a reasonable amount in some other scenarios. This includes, but is not limited to:

A) Hedging strategies with no initial investment that never lose money in any scenario and in some scenarios make money; or

B) Hedging strategies that with a given amount of initial money never make less than accumulation at the one-period risk-free rates in any scenario but make more than this in one or more scenarios.

If the stochastic cash flow model allows for such situations, the actuary should be satisfied that the results do not materially rely directly or indirectly on the use of such strategies. In addition, the actuary should disclose the situations and provide supporting documentation as to why the actuary believes the situations are not material for determining the Conditional Tail Expectation Amount. If the results do materially rely directly or indirectly on the use of such strategies, the strategies may not be used to reduce the Conditional Tail Expectation Amount otherwise calculated.

In addition to the above, the method used to determine prices of financial instruments for trading in scenarios should be compared to actual initial market prices. If there are substantial discrepancies, the actuary should disclose the substantial discrepancies and provide supporting documentation as to why the model-based prices are appropriate for determining the Conditional Tail Expectation Amount. In addition to comparisons to initial market prices, there should be testing of the pricing models that are used to determine subsequent prices when scenarios involve trading financial instruments. This testing should consider historical relationships. For example, if a method is used where recent volatility in the scenario is one of the determinants of prices for trading in that scenario, then that model should approximate actual historic prices in similar circumstances in history.

A7.5) Certification and Documentation

The actuary must provide a certification that the values for E, CTE Amount(adjusted) and CTE Amount(best efforts) were calculated using the process discussed above and the assumptions used in the calculations were reasonable for the purpose of determining the Conditional Tail Expectation Amount. The actuary shall document the method(s) and assumptions (including data) used to determine CTE Amount(adjusted) and CTE Amount(best efforts) and maintain adequate documentation as to the methods, procedures and assumptions used to determine the value of E.

The actuary must provide a certification as to whether the Clearly Defined Hedging Strategy is fully incorporated into the stochastic cash flow model and any supplementary analysis of the impact of the hedging strategy on the Conditional Tail Expectation Amount. The actuary must document the extent to which elements of the hedging strategy (e.g., time between portfolio rebalancing) are not fully incorporated into the stochastic cash flow model and any supplementary analysis to determine the impact, if any. In addition, the actuary must provide a certification and maintain documentation to support the certification that the hedging strategy designated as the Clearly Defined Hedging Strategy meets the requirements of a Clearly Defined Hedging Strategy including that the implementation of the hedging strategy in the stochastic cash flow model and any supplementary analysis does not include knowledge of events that occur after any action dictated by the hedging strategy (i.e., the model cannot use information about the future that would not be known in actual practice).
A financial officer of the company (e.g., Chief Financial Officer, Treasurer or Chief Investment Officer) or a person designated by them who has direct or indirect supervisory authority over the actual trading of assets and derivatives must certify that the hedging strategy meets the definition of a Clearly Defined Hedging Strategy and that the Clearly Defined Hedging Strategy is the hedging strategy being used by the company in its actual day to day risk mitigation efforts.
APPENDIX 8 – Certification Requirements

A8.1) Management Certification

Management must provide signed and dated written representations as part of the valuation documentation that the valuation appropriately reflects management’s intent and ability to carry out specific courses of actions on behalf of the entity where such is relevant to the valuation. This certification will be submitted no later than March 1. Upon written request by the company, the commissioner may grant an extension of the date for submission of the certification.

A8.2) Actuarial Certification

A) General Description. The certification shall be provided by a qualified actuary and consist of at least the following:

1) A paragraph identifying the actuary and his or her qualifications;

2) A scope paragraph identifying the reserves as of the valuation date for contracts included in the certification categorized by the approaches used to determine the reserves (e.g., Alternative Methodology, Projections, Standard Scenario);

3) A reliance paragraph describing those areas, if any, where the certifying actuary has relied on other experts;
   a) A reliance statement from each of those relied on should accompany the certification.
   b) The reliance statements should note the information being provided and a statement as to the accuracy, completeness or reasonableness, as applicable, of the information.

4) A paragraph certifying that the reserve was calculated in accordance with the principles and requirements of the Guideline;

5) A paragraph certifying that the assumptions used for these calculations are Prudent Estimate assumptions for the products, scenarios, and purpose being tested; and

6) A paragraph stating that the qualified actuary is not opining on the adequacy of the company’s surplus or its future financial condition.

7) This certification will be submitted no later than March 1. Upon written request by the company, the commissioner may grant an extension of the date for submission of the certification.

A8.3) Supporting Memorandum

A) General Description. A supporting memorandum shall be created to document the methodology and assumptions used to determine the Aggregate Reserve. The information shall include the comparison of the Standard Scenario Amount to the Conditional Tail Expectation Amount required by Section IV)A) in the determination of the Aggregate Reserve.

B) Alternative Methodology using Published Factors.

1) If a seriatim approach was not used, disclose how contracts were grouped.
Appendix C

2) Disclosure of assumptions to include:
   a) Component CA
      (i) Mapping to prescribed asset categories
      (ii) Lapse and withdrawal rates
   b) Component FE
      (i) Determination of fixed dollar costs and revenues
      (ii) Lapse and withdrawal rates
      (iii) Inflation rates
   c) Component GC
      (i) Disclosure of contract features and how the company mapped the contract form to those forms covered by the Alternative Methodology factors
         - Product Definition - If not conservatively assigned to a published factor, company specific factors or stochastic modeling is required.
         - Partial Withdrawal Provision
         - Fund Class - Disclose the process used to determine the single asset class that best represents the exposure for a contract. If individual funds are mapped into prescribed categories, the process used to map the individual funds should be disclosed.
         - Attained Age
         - Contract Duration
         - Ratio of Account Value to Guaranteed Value
         - Annualized Account Charge Differential from Base Assumption
      (ii) Derivation of Equivalent Account Charges
      (iii) Derivation of margin offset
      (iv) Disclosure of interpolation procedures and confirmation of node determination
   
3) Disclosure, if applicable, of reinsurance that exists and how it was handled in applying published factors (For some reinsurance, creation of company-specific factors or stochastic modeling may be required.).
   a) Discuss how reserves before reinsurance were determined.

C) Alternative Factors based on Company-Specific Factors.

1) Disclosure of requirements consistent with Published Factors, as noted in subsection B) above.

2) Stochastic analysis supporting adjustments to published factors should be fully documented. This analysis needs to be submitted when initially used and be available upon request in subsequent years. Adjustments may include:
   a) Contract design;
   b) Risk mitigation strategy (excluding hedging); and
   c) Reinsurance.

D) Stochastic Modeling.

1) Assets
   a) Description including type and quality
   b) Investment & disinvestment assumptions
   c) Describe assets used at the start of the projection
   d) Source of asset data
e) Asset valuation basis
f) Documentation of assumptions
   (i) Default costs
   (ii) Prepayment functions
   (iii) Market value determination
   (iv) Yield on assets acquired
   (v) Mapping and grouping of funds to modeled asset classes
g) Hedging Strategy
   (i) Documentation of strategy
   (ii) Identification of current positions
   (iii) Description on how strategy was incorporated into modeling
      - Basis risk, gap risk, price risk, assumption risk
      - Document the methods and criterion used to estimate the a priori effectiveness of the hedging strategy
   (iv) Documentation required for specific consideration raised in section A7.4).
   (v) Documentation and certification required by section A7.5).

2) Liabilities
   a) Product descriptions
   b) Source of Liabilities
   c) Grouping of contracts
   d) Reserve method and modeling (e.g., Working Reserves were set to CSV)
   e) Investment Reserves
   f) Describe how reinsurance was handled in the models, including how reserves gross of reinsurance were modeled.
   g) Documentation of assumptions (i.e., list assumptions, discuss the sources and the rationale for using the assumptions).
      (i) Premiums and subsequent deposits
      (ii) Withdrawal, Lapse and Termination Rates
         - Partial Withdrawal (including treatment of dollar-for-dollar offsets on GMDBs and VAGLBs, and Required Minimum Distributions
         - Lapses / Surrenders
      (iii) Crediting Strategy
      (iv) Mortality
      (v) Annuitzation rates
      (vi) Income Purchase rates
      (vii) GMIB and GMWB Utilization rates
      (viii) Commissions
      (ix) Expenses
      (x) Persistency Bonuses
      (xi) Investment / Fund Choice
      (xii) Revenue Sharing
      (xiii) Asset Allocation, Rebalancing and Transfer Assumptions
         - Dollar Cost Averaging
   h) The section showing the assumptions used for lapse and utilization assumptions for contracts with guaranteed living benefits in the development of the Conditional Tail Expectation Amount, as described in section A9.7).

3) Scenarios
   a) Description of scenario generation for interest rates and equity returns
(i) Disclose the number “n” of scenarios used and the methods used to determine the sampling error of the CTE(70) statistic when using “n” scenarios.

(ii) Time step of model (e.g., monthly, quarterly, annual)

(iii) Correlation of fund returns

b) Calibration

(i) Gross Wealth Ratios for equity funds
   - Disclosure of adjustments to model parameters, if any.
   - Disclosure of 1-year, 5-year and 10-year wealth factors, as well as mean and standard deviation.

(ii) Consistency of other funds to equity funds

(iii) Correlation between all funds

(iv) Estimate of market return volatility assumptions underlying the generated scenarios compared to actual observed volatility underlying market values.

c) Extent of use of pre-packaged scenarios and support for mapping variable accounts to proxy funds

4) Description and results of sensitivity tests performed. At the request of the domiciliary commissioner, the company shall provide a sensitivity test showing an estimate of the impact of the market return volatility assumption when market volatility is materially higher than assumed in the generated scenarios.

5) Documentation of all material changes in the model or assumptions from that used previously and the estimated impact of such changes. This documentation, or a summary of this documentation, shall be included in an executive summary or some other prominent place in the memorandum.

6) A description of the methods used to validate the model and a summary of the results of the validation testing.

E) Standard Scenario.

1) For the amounts in 2), 3) and 4) below report the Basic Reserve in A3.3)B)2)a), the projection requirements in A3.3)B)2)b), the value of Aggregate reinsurance in A3.3)D)1), the value of hedges in A3.3)D)(2), the total allocation of the value of hedges and Aggregate reinsurance in A3.3)B)2)c) and the Standard Scenario Reserve.

2) Report the Standard Scenario Amount as of the valuation date.

3) If applicable, report the Standard Scenario Amount on the inforce prior to the valuation date that was used to project the reserve requirements to the valuation date.

4) If applicable, report the Standard Scenario Amount on the model office used to represent the inforce.

5) Discuss modifications, if any, in the application of the standard scenario requirements to produce the amounts in 2), 3) and 4) above.

6) Document any assumptions, judgments or procedures not prescribed in the Standard Scenario Method or in the Guideline that are used to produce the Standard Scenario Amount.
7) If applicable, documentation of approval by the commissioner to use the Basic Reserve as the Standard Scenario Amount.

8) Document the company’s calculation of DR.

9) Document the allocation of funds to Equity, Bond, Balanced and Fixed classes.

10) A statement by the actuary that none of the reinsurance treaties included in the Standard Scenario serve solely to reduce the calculated Standard Scenario Reserve without also reducing risk on scenarios similar to those used to determine the Conditional Tail Expectation Reserve. This should be accompanied by a description of any reinsurance treaties that have been excluded from the Standard Scenario along with an explanation of why the treaty was excluded.

F) The memorandum shall be made available for examination by the commissioner upon his or her request but shall be returned to the company after such examination and shall not be considered a record of the insurance department or subject to automatic filing with the commissioner.
APPENDIX 9 – Contractholder Behavior

A9.1) General

Contractholder behavior assumptions encompass actions such as lapses, withdrawals, transfers, recurring deposits, benefit utilization, option election, etc. Contractholder behavior is difficult to predict and behavior assumptions can significantly impact the results. In the absence of relevant and fully credible empirical data, the actuary should set behavior assumptions on the conservative end of the plausible spectrum (consistent with the definition of Prudent Estimate).

In setting behavior assumptions, the actuary should examine, but not be limited by, the following considerations:

1) Behavior can vary by product, market, distribution channel, fund performance, time/product duration, etc.

2) Options embedded in the product may impact behavior.

3) Options may be elective or non-elective in nature. Living benefits are often elective and death benefit options are generally non-elective.

4) Elective contractholder options may be more driven by economic conditions than non-elective options.

5) As the value of a product option increases, there is an increased likelihood that contractholders will behave in a manner that maximizes their financial interest (e.g., lower lapses, higher benefit utilization, etc.).

6) Behavior formulas may have both rational and irrational components (irrational behavior is defined as situations where some contractholders may not always act in their best financial interest). The rational component should be dynamic but the concept of rationality need not be interpreted in strict financial terms and might change over time in response to observed trends in contractholder behavior based on increased or decreased financial efficiency in exercising their contractual options.

7) Options that are ancillary to the primary product features may not be significant drivers of behavior. Whether an option is ancillary to the primary product features depends on many things such as:
   a) For what purpose was the product purchased?
   b) Is the option elective or non-elective?
   c) Is the value of the option well known?

8) External influences, including emergence of viatical / life settlement companies, may impact behavior.

A9.2) Aggregate vs. Individual Margins

As noted in Section III)(B)8), Prudent Estimate assumptions are developed by applying a margin for uncertainty to the Anticipated Experience assumption. The issue of whether the level of the margin applied to the Anticipated Experience assumption is determined in aggregate or independently for each and every behavior assumption is discussed in Principle 3 in Section II) of this Guideline, which states:
The choice of a conservative estimate for each assumption may result in a distorted measure of the total risk. Conceptually, the choice of assumptions and the modeling decisions should be made so that the final result approximates what would be obtained for the Conditional Tail Expectation Amount at the required CTE level if it were possible to calculate results over the joint distribution of all future outcomes. In applying this concept to the actual calculation of the Conditional Tail Expectation Amount, the actuary should be guided by evolving practice and expanding knowledge base in the measurement and management of risk.

Although this Principle discusses the concept of determining the level of margins in aggregate, it notes that the application of this concept shall be guided by evolving practice and expanding knowledge. From a practical standpoint, it may not always be possible to completely apply this concept to determine the level of margins in aggregate for all behavior assumptions.

Therefore, the actuary shall determine Prudent Estimate assumptions independently for each behavior (e.g., mortality lapses, and benefit utilization), using the requirements and guidance in this Appendix and throughout the guideline, unless the actuary can demonstrate that an appropriate method was used to determine the level of margin in aggregate for two or more behaviors.

A9.3) Sensitivity Testing

The impact of behavior can vary by product, time period, etc. Sensitivity testing of assumptions is required and shall be more complex than e.g., base lapse assumption minus 1% across all contracts. A more appropriate sensitivity test in this example might be to devise parameters in a dynamic lapse formula to reflect more out-of-the-money contracts lapsing and/or more holders of in-the-money contracts persisting and eventually utilizing the guarantee. The actuary should apply more caution in setting assumptions for behaviors where testing suggests that stochastic modeling results are sensitive to small changes in such assumptions. For such sensitive behaviors, the actuary shall use higher margins when the underlying experience is less than fully relevant and credible.

A9.4) Specific Considerations and Requirements

Within materiality considerations, the actuary should consider all relevant forms of contractholder behavior and persistency, including but not limited to the following:

1) Mortality (additional guidance and requirements regarding mortality is contained in Appendix 10)
2) Surrenders
3) Partial Withdrawals (Systematic and Elective)
4) Fund Transfers (Switching/Exchanges)
5) Resets/Ratchets of the Guaranteed Amounts (Automatic and Elective)
6) Future Deposits

It may be acceptable to ignore certain items that might otherwise be explicitly modeled in an ideal world, particularly if the inclusion of such items reduces the calculated provisions. For example:
1) The impact of fund transfers (intra-contract fund “switching”) might be ignored, unless required under the terms of the contract (e.g., automatic asset re-allocation/rebalancing, dollar cost averaging accounts, etc.)

2) Future deposits might be excluded from the model, unless required by the terms of the contracts under consideration and then only in such cases where future premiums can reasonably be anticipated (e.g., with respect to timing and amount).

However, the actuary should exercise caution in assuming that current behavior will be indefinitely maintained. For example, it might be appropriate to test the impact of a shifting asset mix and/or consider future deposits to the extent they can reasonably be anticipated and increase the calculated amounts.

Normally, the underlying model assumptions would differ according to the attributes of the contract being valued. This would typically mean that contractholder behavior and persistency may be expected to vary according to such characteristics as (this is not an exhaustive list):

1) Gender
2) Attained age
3) Issue age
4) Contract duration
5) Time to maturity
6) Tax status
7) Fund value
8) Investment option
9) Guaranteed benefit amounts
10) Surrender charges, transaction fees or other contract charges
11) Distribution channel

Unless there is clear evidence to the contrary, behavior assumptions should be no less conservative than past experience. Margins for contractholder behavior assumptions shall assume, without relevant and credible experience or clear evidence to the contrary, that contractholders’ efficiency will increase over time.

In determining contractholder behavior assumptions, the company shall use actual experience data directly applicable to the business segment (i.e., direct data) if it is available. In the absence of direct data, the company should then look to use data from a segment that are similar to the business segment (i.e., other than direct experience), whether or not the segment is directly written by the company. If data from a similar business segment are used, the assumption shall be adjusted to reflect differences between the two segments. Margins shall reflect the data uncertainty associated with using data from a similar but not identical business segment. The actuary shall document any significant similarities or differences between the two business segments, the data quality of the similar business segment and the adjustments and the margins applied.
Where relevant and fully credible empirical data do not exist for a given contractholder behavior assumption, the actuary shall set the contractholder behavior assumption to reflect the increased uncertainty such that the contractholder behavior assumption is shifted towards the conservative end of the plausible range of expected experience that serves to increase the Aggregate Reserve. If there are no relevant data, the actuary shall set the contractholder behavior assumption to reflect the increased uncertainty such that the contractholder behavior assumption is at the conservative end of the range. Such adjustments shall be consistent with the definition of Prudent Estimate, with the Principles described in Section I, and with the guidance and requirements in this Appendix.

Ideally, contractholder behavior would be modeled dynamically according to the simulated economic environment and/or other conditions. It is important to note, however, that contractholder behavior should neither assume that all contractholders act with 100% efficiency in a financially rational manner nor assume that contractholders will always act irrationally.

**A9.5) Dynamic Assumptions**

Consistent with the concept of Prudent Estimate assumptions described earlier, the liability model should incorporate margins for uncertainty for all risk factors which are not dynamic (i.e., the non-scenario tested assumptions) and are assumed not to vary according to the financial interest of the contractholder.

The actuary should exercise care in using static assumptions when it would be more natural and reasonable to use a dynamic model or other scenario-dependent formulation for behavior. With due regard to considerations of materiality and practicality, the use of dynamic models is encouraged, but not mandatory. Risk factors which are not scenario tested, but could reasonably be expected to vary according to a stochastic process, or future states of the world (especially in response to economic drivers) may require higher margins and/or signal a need for higher margins for certain other assumptions.

Risk factors that are modeled dynamically should encompass the plausible range of behavior consistent with the economic scenarios and other variables in the model, including the non-scenario tested assumptions. The actuary shall test the sensitivity of results to understand the materiality of making alternate assumptions and follow the guidance discussed above on setting assumptions for sensitive behaviors.

**A9.6) Consistency with the CTE Level**

All behaviors (i.e., dynamic, formulaic and non-scenario tested) should be consistent with the scenarios used in the CTE calculations (generally, the approximately top 1/3 of the loss distribution). To maintain such consistency, it is not necessary to iterate (i.e., successive runs of the model) in order to determine exactly which scenario results are included in the CTE measure. Rather, in light of the products being valued, the actuary should be mindful of the general characteristics of those scenarios likely to represent the tail of the loss distribution and consequently use Prudent Estimate assumptions for behavior that are reasonable and appropriate in such scenarios. For variable annuities, these “valuation” scenarios would typically display one or more of the following attributes:

1) Declining and/or volatile separate account asset values;
2) Market index volatility, price gaps and/or liquidity constraints;
3) Rapidly changing interest rates.

The behavior assumptions should be logical and consistent both individually and in aggregate, especially in the scenarios that govern the results. In other words, the actuary should not set behavior assumptions in isolation, but give due consideration to other elements of the model. The interdependence of assumptions
(particularly those governing customer behaviors) makes this task difficult and by definition requires professional judgment, but it is important that the model risk factors and assumptions:

1) Remain logically and internally consistent across the scenarios tested;

2) Represent plausible outcomes; and

3) Lead to appropriate, but not excessive, asset requirements.

The actuary should remember that the continuum of “plausibility” should not be confined or constrained to the outcomes and events exhibited by historic experience.

Companies should attempt to track experience for all assumptions that materially affect their risk profiles by collecting and maintaining the data required to conduct credible and meaningful studies of contractholder behavior.

A9.7) Additional Considerations and Requirements for Assumptions Applicable to Guaranteed Living Benefits

Experience for contracts without guaranteed living benefits may be of limited use in setting a lapse assumption for contracts with in-the-money or at-the-money guaranteed living benefits. Such experience may only be used if it is appropriate (e.g., lapse experience on contracts without a living benefit may have relevance to the early durations of contracts with living benefits) and relevant to the business and is accompanied by documentation that clearly demonstrates the relevance of the experience, as discussed in the following paragraph.

The supporting memorandum required by Appendix 8 of this Guideline, shall include a separately identifiable section showing the assumptions used for lapse and utilization assumptions for contracts with guaranteed living benefits in the development of the Conditional Tail Expectation Amount. This section shall be considered part of the supporting memorandum and shall show the formulas used to set the assumptions and describe the key parameters affecting the level of the assumption (e.g., age, duration, in-the-moneyness, during and after the surrender charge period). The section shall include a summary that shows the lapse and utilization rates that result from various combinations of the key parameters. The section shall show any experience data used to develop the assumptions and describe the source, relevance and credibility of that data. If relevant and credible data were not available, the section should discuss how the assumption is consistent with the requirement that the assumption is to be on the conservative end of the plausible range of expected experience. The section shall also discuss the sensitivity tests performed to support the assumption. This separately identifiable section shall be made available on a standalone basis if requested by the Domiciliary Commissioner. If it is requested, the section shall have the same confidential status as the supporting memorandum and the actuarial memorandum supporting the actuarial opinion, as discussed in section A2.3)B).

Regarding lapse assumptions for contracts with guaranteed living benefits, the section shall include, at a minimum, the following:

1) Actual to expected lapses on two bases, where “expected” equals one of the following:
   a) Prudent estimate assumptions used in the development of the Conditional Tail Expectation Amount;
   b) The assumptions used in the Standard Scenario;

2) The lapse assumptions used in the development of Conditional Tail Expectation Amount and corresponding actual experience separated by:
   a) Logical blocks of business (based on company’s assessment);
b) Duration (at a minimum this should show during the surrender charge period vs. after the surrender charge period);
c) In-the-moneyness (consistent with how dynamic assumptions are determined); and
d) Age (to the extent age impacts the election of benefits lapse).

This data shall be separated by experience incurred in the following periods:

a) In the past year;
b) In the past three years; and
c) All years.
APPENDIX 10 – Specific Guidance and Requirements for Setting Prudent Estimate Mortality Assumptions

A10.1) Overview

A) Intent. The guidance and requirements in this Appendix apply for setting Prudent Estimate mortality assumptions when determining the Conditional Tail Expectation Amount (whether using projections or the Alternative Methodology). The intent is for Prudent Estimate mortality assumptions to be based on facts, circumstances, and appropriate actuarial practice (where more than one approach to appropriate actuarial practice exists, the actuary should select the practice that the actuary deems most appropriate under the circumstances) with only a limited role for unsupported actuarial judgment.

B) Description. Prudent Estimate mortality assumptions are determined by first developing expected mortality curves based on either available experience or published tables. Where necessary, margins are applied to the experience to reflect data uncertainty. The expected mortality curves are then adjusted based on the credibility of the experience used to determine the expected mortality curve. Section A10.2) addresses guidance and requirements for determining expected mortality curves and section A10.3) addresses guidance and requirements for adjusting the expected mortality curves to determine Prudent Estimate mortality.

Finally, the credibility-adjusted tables shall be adjusted for mortality improvement (where such adjustment is permitted or required) using the guidance and requirements in section A10.4).

C) Business Segments. For purposes of setting Prudent Estimate mortality assumptions, the products falling under the scope of the Guideline shall be grouped into business segments with different mortality assumptions. The grouping should generally follow the pricing, marketing, management and/or reinsurance programs of the company. Where less refined segments are used for setting the mortality assumption than is used in business management the documentation should address the impact, if material, of the less refined segmentation on the resulting reserves.

D) Margin for Data Uncertainty. The expected mortality curves that are determined in section A10.2) may need to include a margin for data uncertainty. The margin could be in the form of an increase or a decrease in mortality, depending on the business segment under consideration. The margin shall be applied in a direction (i.e., increase or decrease in mortality) that results in a higher reserve. A sensitivity test may be needed to determine the appropriate direction of the provision for uncertainty to mortality. The test could be a prior year mortality sensitivity analysis of the business segment or an examination of current representative cells of the segment.

For purposes of this Appendix, if mortality must be increased (decreased) to provide for uncertainty the business segment is referred to as a plus (minus) segment.

It may be necessary, because of a change in the mortality risk profile of the segment, to reclassify a business segment from a plus (minus) segment to a minus (plus) segment to the extent compliance with this subsection requires such a reclassification.

A10.2) Determination of Expected Mortality Curves

A) Experience Data. In determining expected mortality curves the company shall use actual experience data directly applicable to the business segment (i.e., direct data) if it is available. In the absence of direct data, the company should then look to use data from a segment that is similar to the business segment (i.e., other than direct experience). See section B) below for
additional considerations. Finally, if there is no data, the company shall use the applicable table, as required in subsection C) below.

B) Data Other than Direct Experience. If expected mortality curves for a segment are being determined using data from a similar business segment (whether or not directly written by the company), the actuary shall document any similarities or differences between the two business segments (e.g., type of underwriting, marketing channel, average policy size, etc.). The actuary shall also document the data quality of the mortality experience of the similar business. Adjustments shall be applied to the data to reflect differences between the business segments and margins shall be applied to the adjusted expected mortality curves to reflect the data uncertainty associated with using data from a similar but not identical business segment. The actuary shall document the adjustments and the margins applied.

To the extent the mortality of a business segment is reinsured, any mortality charges that are consistent with the company’s own pricing and applicable to a substantial portion of the mortality risk may also be a reasonable starting point for the determination of the company’s expected mortality curves. The actuary shall document the application of such reinsurance charges and how they were used to set the company’s expected mortality curves for the segment.

C) No Data Requirements. When little or no experience or information is available on a business segment, the company shall use expected mortality curves that would produce expected deaths no less than using 100% of the 1994 Variable Annuity MGDB mortality table for a plus segment and expected deaths no greater than 100% of the Annuity 2000 table for a minus segment. If mortality experience on the business segment is expected to be atypical (e.g., demographics of target markets are known to have higher (lower) mortality than typical), these “no data” mortality requirements may not be adequate.

D) Additional Considerations Involving Data. The following considerations shall apply to mortality data specific to the business segment for which assumptions are being determined (i.e., direct data discussed in subsection A) above or other than direct data discussed in subsection B) above).

1) Underreporting of deaths. Mortality data shall be examined for possible underreporting of deaths. Adjustments shall be made to the data if there is any evidence of underreporting. Alternatively, exposure by lives or amounts on contracts for which death benefits were in the money may be used to determine expected mortality curves. Underreporting on such exposures should be minimal; however, this reduced subset of data will have less credibility.

2) Experience by contract duration. Experience of a plus segment shall be examined to determine if mortality by contract duration increases materially due to selection at issue. In the absence of information, the actuary shall assume that expected mortality will increase by contract duration for an appropriate select period. As an alternative, if the actuary determines that mortality is impacted by selection, the actuary could apply margins to the expected mortality in such a way that the actual mortality modeled does not depend on contract duration.

3) Modification and Relevance of data. Even for a large company the quantity of life exposures and deaths are such that a significant amount of smoothing may be required to determine expected mortality curves from mortality experience. Expected mortality curves, when applied to the recent historic exposures (e.g., 3 to 7 years), should not result in an estimate of aggregate number of deaths less (greater) than the actual number deaths during the exposure period for plus (minus) segments. If this condition is not satisfied,
the actuary must document the rationale in support of using expected mortality that differs from recent mortality experience.

In determining expected mortality curves (and the credibility of the underlying data), older data may no longer be relevant. The “age” of the experience data used to determine expected mortality curves should be documented. There should be commentary in the documentation on the relevance of the data (e.g., any actual and expected changes in markets, products and economic conditions over the historic and projected experience).

4) Other considerations. In determining expected mortality curves, consideration should be given to factors that include, but are not limited to, trends in mortality experience, trends in exposure, volatility in year-to-year A/E mortality ratios, mortality by lives relative to mortality by amounts, changes in the mix of business and product features that could lead to mortality selection.

E) Documentation Requirements.

1) All Segments. The documentation should include any material considerations necessary to understand the development of mortality assumptions for the statutory valuation even if such considerations are not explicitly mentioned in this section. The documentation should be explicit when material judgments were required and such judgments had to be made without supporting historic experience.

The documentation shall:

a) Explain the rationale for the grouping of contracts into different segments for the determination of mortality assumptions and characterize the type and quantity of business that constitute each segment.

b) Describe how each segment was determined to be a plus or minus segment.

c) Summarize any mortality studies used to support mortality assumptions, quantify the exposures and corresponding deaths, describe the important characteristics of the exposures and comment on unusual data points or trends.

d) Document the age of the experience data used to determine expected mortality curves and comment on the relevance of the data.

e) Document the mathematics used to adjust mortality based on credibility and summarize the result of applying credibility to the mortality segments.

f) Discuss any assumptions made on mortality improvements, the support for such assumptions and how such assumptions adjusted the modeled mortality.

g) Describe how the expected mortality curves compare to recent historic experience and comment on any differences.

h) Discuss how the mortality assumptions are consistent with the goal of achieving the required CTE level over the joint distribution of all future outcomes, in keeping with Principle #3 and Appendix 9.

If the study was done on a similar business segment, identify the differences in the business segment on which the data were gathered and the business segment on which the data were used to determine mortality assumptions for the statutory valuation. Describe how these differences were reflected in the mortality used in modeling.

If mortality assumptions for the statutory valuation were based in part on reinsurance rates, document how the rates were used to set expected mortality (e.g., assumptions made on loadings in the rates and/or whether the assuming company provided their expected mortality and the rationale for their assumptions).
2) **Plus Segments.** For a plus segment, the documentation shall also discuss the examination of the mortality data for the underreporting of deaths and experience by duration, and describe any adjustments that were made as a result of the examination.

3) **Minus Segments.** For a minus segment the documentation shall also discuss how the mortality deviations on minus segments compare to those on any plus segments. To the extent the overall margin is reduced, the documentation should include support for this assumption.

A10.3) **Adjustment for Credibility to Determine Prudent Estimate Mortality**

A) **Adjustment for Credibility.** The expected mortality curves determined in section A10.2) shall be adjusted based on the credibility of the experience used to determine the curves in order to arrive at Prudent Estimate mortality. The adjustment for credibility shall result in blending the expected mortality curves with a mortality table consistent with a statutory valuation mortality table. For a plus segment, the table shall be consistent with 100% of the 1994 Variable Annuity MGDB table (or a more recent mortality table adopted by the NAIC to replace this table). For a minus segment, the table shall be consistent with 100% of the 2000 Annuity table (or a more recent mortality table adopted by the NAIC to replace that table). The approach used to adjust the curves shall suitably account for credibility.40

B) **Adjustment of Statutory Valuation Mortality for Improvement.** For purposes of the adjustment for credibility, the statutory valuation mortality table for a plus segment may be and the statutory valuation mortality table for a minus segment must be adjusted for mortality improvement. Such adjustment shall reflect applicable published industrywide experience from the effective date of the respective statutory valuation mortality table to the experience weighted average date underlying the data used to develop the expected mortality curves (discussed in section A10.2)).

C) **Credibility Procedure.** The credibility procedure used shall:

1) Produce results that are reasonable in the professional judgment of the actuary,

2) Not tend to bias the results in any material way,

3) Be practical to implement,

4) Give consideration to the need to balance responsiveness and stability,

5) Take into account not only the level of aggregate claims but the shape of the mortality curve, and

6) Contain criteria for full credibility and partial credibility that have a sound statistical basis and be appropriately applied.

Documentation of the credibility procedure used shall include a description of the procedure, the statistical basis for the specific elements of the credibility procedure, and any material changes from prior credibility procedures.

D) **Further Adjustment of the Credibility-adjusted Table for Mortality Improvement.** The credibility-adjusted table used for plus segments may be and the credibility adjusted date used for minus

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40 For example, when credibility is zero, an appropriate approach should result in a mortality assumption consistent with 100% of the statutory valuation mortality table used in the blending.
segments must be adjusted for applicable published industrywide experience from the experience weighted average date underlying the company experience used in the credibility process to the valuation date.

Any adjustment for mortality improvement beyond the valuation date is discussed in section A10.4).

**A10.4) Future Mortality Improvement**

The mortality assumption resulting from the requirements of section A10.3) shall be adjusted for mortality improvements beyond the valuation date if such an adjustment would serve to increase the resulting Conditional Tail Expectation Amount. If such an adjustment would reduce the Conditional Tail Expectation Amount, such assumptions are permitted, but not required. In either case, the assumption must be based on current relevant data with a margin for uncertainty (increasing assumed rates of improvement if that results in a higher reserve, reducing them otherwise).
## APPENDIX 11 - 1994 Variable Annuity MGDB Mortality Table

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GROUP TERM LIFE WAIVER OF PREMIUM DISABLED LIFE RESERVES

I. Background

Section 4.G. of the Standard Valuation Law establishes tables approved by the commissioner as the minimum standard for computing reserves for group life insurance and special benefits. The purpose of this Actuarial Guideline (Guideline) is to determine the minimum standard of valuation for group term life waiver of premium disabled life benefits and to recognize the 2005 Group Term Life Waiver (GTLW) Mortality and Recovery Tables.

Group term life policies do not maintain contract reserves beyond the duration of the policy issued to the group policyholder. However, some policies guarantee an extended death benefit to an individual insured who is disabled according to the terms of the policy. Thus, to the extent such guarantees are made, a disabled life reserve must be maintained for each individual that is so disabled. However, prior to the creation of this guideline, there has been no formal guidance regarding the calculation of these disabled life reserves.

II. Scope

This guideline applies to group term life certificates on individuals who become disabled on or after January 1, 2009. Based on the provisions of Section 4.G. of the Standard Valuation Law, companies may apply this to group term life certificates on individuals who became disabled prior to January 1, 2009, provided they obtain permission from the commissioner.

III. Definitions

“2005 GTLW Mortality Tables” means the mortality rate tables shown in Attachments A and B.

“2005 GTLW Recovery Tables” means the recovery rate tables shown in Attachments C and D.

IV. Text

A. Group Waiver of Premium Reserve Calculation

1. The minimum standard of valuation for group term life waiver of premium disabled life benefits shall be the present value of the death benefit payable discounted for interest and recovery. Since there is not a contract reserve based upon an aggregate table, the discounted value of waived premiums is inadequate to support this liability.

2. Except as provided in Section B, the 2005 GTLW Mortality and Recovery Tables shall be used for determining the minimum standard of valuation for any group term life waiver of premium disabled life benefit incurred on or after the effective date of this guideline. The valuation tables were derived from employer-employee group life experience. Other forms of group term life insurance are also subject to the same requirements if they contain similar extended death benefit provisions. Section B offers ways to modify the underlying rates of mortality or recovery if they differ from those associated with the underlying experience in the valuation table.
3. The maximum interest rate shall be the maximum rate permitted by law in the valuation of life insurance of the same guaranteed duration issued on the same date as the claim incurrence date of disability. This maximum interest rate shall be used for determining the minimum standard of valuation for any group term life waiver of premium disabled life benefit incurred on or after the effective date of this guideline. The guaranteed duration used to determine the life insurance rate of interest is equal to the largest term in years between the point at which any individual in the group may become disabled and the point at which no death benefit is available. Thus, if a person could become disabled at age 20, and remain disabled, and receive a benefit upon death before age 65, the guaranteed duration would be 45 years. For most groups and companies this would mean the maximum interest rate shall be the rate for life insurance with duration greater than 20 years.

B. Use of Company Experience

1. The Appointed Actuary shall review company experience at least once every five years. The review of company experience can range from a detailed experience study to a high level analysis. The extent of the review must be sufficient to enable the Appointed Actuary to defend any conclusion reached. Company experience shall:

i. Be segmented into policies with similar benefits, on individuals of each gender;

ii. Be experience-specific to the company;

iii. Include all relevant experience in the past three most recent years;

iv. Exclude experience that is not in the past six most recent years;

v. Otherwise be relevant, in accordance with the professional judgment of the Appointed Actuary; and

vi. Not be deemed irrelevant by the commissioner.

2. The commissioner may require a company to use its experience based upon the most recent review referenced in Section B.1 to establish its specific valuation tables if:

i. Actual mortality experience is reasonably expected to be greater than 90% of the 2005 GTLW Mortality Tables; or

ii. Actual recovery experience is reasonably expected to be less than 125% of the 2005 GTLW Recovery Tables.

Under these circumstances, the commissioner may require a company to use the process set out in Section B.4 and establish for the company a minimum value for Z.

3. A company may use its experience exclusively without reference to the standard tabular mortality expected experience or to the standard tabular recovery expected experience to create its specific valuation tables if:
i. The Appointed Actuary can demonstrate and certify the following:

a) The company-specific valuation tables are based on company experience with allowances for graduation and margins for adverse experience;

b) The company-specific mortality valuation tables used for computing minimum reserves for group term life waiver of premium benefits are such that there is at least an 85% statistical confidence that the actual annual aggregate mortality will be less than the mortality in the company-specific-mortality valuation tables; and

c) The company-specific recovery valuation tables used for computing minimum reserves for group term life waiver of premium benefits are such that there is at least an 85% statistical confidence that the actual annual aggregate recoveries will be greater than the recoveries in the company-specific recovery valuation tables.

ii. The company has written permission from the domiciliary commissioner to use the company-specific valuation tables.

iii. Unless otherwise exempted or required, the specific valuation tables shall apply to the computation of minimum reserves for group term life waiver of premium disabled life benefits for claims incurred during or after the calendar year in which the study was performed.

iv. The company shall not use mortality and recovery tables with rates that produce reserves less than the reserves produced by using 75% of the 2005 GTLW Mortality Tables and 160% of the 2005 GTLW Recovery Tables for all durations of disability combined.

4. If not invoking Section B.3, a company may use a credibility-weighted combination of company mortality experience with the 2005 GTLW Mortality Tables and/or of company recovery experience with the 2005 GTLW Recovery Tables to create its specific valuation tables.

i. The blended tables for each gender and type of experience (mortality and recovery) shall be computed using the formula Blended Table = T x S, where:

a) Z shall be a credibility weighting factor, between 0 and 1, developed by the Appointed Actuary using credibility theory methods not unacceptable to the commissioner;

b) F shall be the ratio of the company’s actual experience to the expected experience for the 2005 GTLW Mortality and Recovery Tables for each gender and type of experience (mortality and recovery);
c) M shall be 1.12 for mortality tables and 0.80 for recovery tables. The values provide a smooth transition between the 2005 tables and company experience when Z = 1;

d) S shall be the 2005 GTLW Mortality and Recovery Tables; and

e) T shall be computed using the following steps:

Step 1: Compute the raw value of \( T = [Z \times (F \times M) + (1 - Z)] \).  

Step 2: Round T to the nearest 5%.

Step 3: If the absolute difference between the T produced in step 2 and the value of T utilized immediately prior to the study is less than 10%, then set T equal to the value of T utilized immediately prior to the study.

Step 4: For all durations of disability, combined for each gender, set the value of T to the greater of 75% and the T resulting from step 3 for mortality and set the value of T to the lesser of 160% and the T resulting from step 3 for recovery.

ii. The company has written permission from the domiciliary commissioner to use the blended valuation tables.

iii. Unless otherwise exempted or required, the specific valuation tables shall apply to the computation of minimum reserves for group term life waiver of premium disabled life benefits for claims incurred during or after the calendar year in which the study was performed.
### MALES

**PROBABILITY OF DEATH (1,000Q[X]+T) - SELECT PERIOD**

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### ATTACHMENT B

**2005 GTLW Mortality and Recovery Tables**

Graduated Death Rates (1,000\(Q[X]\))

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2005 GTLW Mortality and Recovery Tables
Graduated Recovery Rates (1,000Q[X])
Ultimate Period (11+ years)
THE APPLICATION OF THE STANDARD NONFORFEITURE LAW FOR LIFE INSURANCE TO CERTAIN POLICIES HAVING INTERMEDIATE CASH BENEFITS

Scope

This Guideline applies to individual life insurance policies, other than variable and non-variable adjustable life policies and current assumption whole life policies, that provide for an endowment benefit, materially less than the policy face amount, at a specified intermediate duration during a longer period of life insurance protection. The payment of such endowment benefit does not alter or eliminate any premiums or benefits scheduled for the period subsequent to the endowment date, nor does the policy automatically terminate upon payment of the endowment benefit. Policies that offer a return of premium endowment benefit may be considered a special case of the policies subject to this Guideline.

Background

In recent years a new category of life insurance products has emerged in the life insurance marketplace. These products offer a cash benefit at a specified time, typically many years prior to the coverage expiry date of the policy, conditioned on the insured being alive and the policy being in force at that time. The cash benefit has often taken the form of an intermediate period endowment that is either built into the policy or is provided through a rider or an endorsement. When the amount of the cash benefit is based upon the premiums paid into the policy, the benefit is often referred to as a return of premium benefit.

The straightforward application of Sections 3 and 5c of the Standard Nonforfeiture Law For Life Insurance (the Law), considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums, can result in negative or very low cash values at all durations for these products. This is caused by high premiums assumed applicable in the later durations. This application of the Law produces unacceptable results, as it fails to recognize that the cash benefit should be prefunded with the premiums that fall due prior to the time the benefit becomes available.

The intent of this Guideline is to provide guidance with respect to the required minimum cash values for some of the products described in the Scope section. However, other products within the scope designed to provide similar benefits, and having similar premium structures (for example products having a cash value at the end of an initial level premium period equal to the total premiums paid) would be expected to provide minimum cash values that are determined in a manner consistent with this Guideline. For products with multiple endowment benefits, the minimum cash values should be determined in accordance with the principles of this Guideline.

Text

A. The following methodology shall be used in the determination of minimum cash surrender values for policies subject to this Guideline in accordance with the requirements of the Law.

1. The endowment period shall be that period of time measured from the issue date of the policy to the date when the endowment benefit becomes payable (the endowment date) under the terms of the policy.

2. If the endowment benefit is added by rider to a policy, then for minimum cash value determination purposes the base policy and the endowment benefit are to be treated as integrated.
3. Premiums under the policy may be provided through a scale of guaranteed rates for the term of the policy or through a scale of current rates that are subject to a scale of guaranteed maximum premiums; if rates are subject to a scale of guaranteed maximum premiums, the minimum cash values shall be the greater of those produced under this Guideline using the guaranteed maximum rates and current rate scale applicable at issue of the policy.

4. Any cash surrender value available under the policy in the event of default in a premium payment due on any policy anniversary during the endowment period shall be an amount not less than the excess, if any, of the present value, on the anniversary, of the endowment benefit and any future incremental death benefits during the endowment period which would have been provided for by the policy if there had been no default, over the sum of:

   (i) The then present value of the adjusted premiums as defined below corresponding to premiums which would have fallen due on and after the anniversary during the endowment period; and

   (ii) The amount of any indebtedness to the company on the policy.

5. Incremental death benefits are death benefits during the endowment period in excess of the lowest death benefit provided under the policy during the endowment period.

6. The adjusted premiums for the policy shall be calculated on an annual basis and shall be such uniform percentage of the respective premiums specified in the policy for each policy year during the endowment period, excluding amounts payable as extra premiums to cover impairments or special hazards and also excluding any uniform annual contract charge or policy fee specified in the policy in a statement of the method to be used in calculating the cash surrender value and paid-up nonforfeiture benefits, that the present value, at the date of issue of the policy, of all adjusted premiums shall be equal to the sum of:

   (i) The present value of the endowment benefit and any incremental death benefits provided for by the policy during the endowment period;

   (ii) One percent (1%) of the average amount of insurance (total death benefit under the policy, including any incremental death benefits) at the beginning of each of the first ten policy years; and

   (iii) One hundred twenty-five percent (125%) of the nonforfeiture net level premium as defined below, provided however, that no nonforfeiture net level premium shall be considered to exceed 4% of the average amount of insurance (total death benefit under the policy, including any incremental death benefits) at the beginning of each of the first ten policy years.

7. The nonforfeiture net level premium for the policy shall be equal to the present value, at the date of issue of the policy, of the endowment benefit and any incremental death benefits provided for by the policy during the endowment period, divided by the present value, at the date of issue of the policy, of an annuity of one per annum payable on the date of issue of the policy and on each anniversary of such policy on which a premium falls due prior to the endowment date.
8. The mortality rates and interest rate used in the determination of the minimum cash values for the policy shall be those applicable under the Law considering during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums.

B. In no event can the cash surrender value under the policy at any duration be less than the greater of:

1. The minimum cash value calculated according to Section A of this Guideline; and

2. The minimum cash value at the same duration resulting from the application of the methods described in Sections 3 and 5c of the Law considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums. In performing this calculation, no annual premium at any duration after the endowment period shall exceed the difference between the death benefit and the cash value at that duration.

C. The cash surrender values for the policy must also satisfy the consistency of progression of cash values test contained in Section 8 of the Law, considering guaranteed benefits and premiums (whether guaranteed or indeterminate) during the entire period death benefits are guaranteed available under the policy, subject only to the payment of required premiums.

D. For policies where the benefit is defined in more general terms as providing for a return of premiums paid or a portion of premiums paid, the procedures of Subsection 5c C of the Law and the requirements of Section A above shall be applied in the determination of a revised set of minimum cash values in the event the value of the endowment benefit of the policy changes due to a change made to the premium schedule provided at issue.

**Applicability**

This Guideline is effective for all policy forms filed on or after January 1, 2009, and affects all contracts issued on or after January 1, 2010.
I. Background

Some states have revised their regulation permitting the use of the 2001 CSO Preferred Class Structure Mortality Table so that at the company’s option it might be used to value a policy on a plan which was previously approved for issue based on valuation using the 2001 CSO Mortality Table. A company making this election would be changing the valuation mortality rates. It is also the case that use of the 2001 CSO Preferred Class Structure Mortality Table is predicated upon the block of policies initially, and annually thereafter, satisfying certain requirements with respect to the present value of death benefits over certain future periods. If these requirements are not satisfied at some point in the future, the company must change to a table for which the requirements are satisfied. For example, this could mean changing from the super preferred nonsmoker table to the preferred nonsmoker table or maybe from the preferred smoker table to the smoker table. Although a non-elective change, this is also a change in the valuation mortality rates.

Section 4B of the Valuation of Life Insurance Policies Model Regulation defines the “Contract Segmentation Method” in which segments are to be calculated using the valuation mortality rates for deficiency reserves. Thus, potentially either of the two examples given above could trigger a recalculation of the valuation segments at the time the valuation mortality rates are changed. The purpose of this guideline is to prescribe which circumstances involving a change to the valuation mortality rates, require a recalculation of the segments and which do not.

The Valuation of Life Insurance Policies Model Regulation was adopted, in part, to stop the use of high net premiums late in the policy’s life from unduly influencing the level of reserves early in the policy’s life (“postfunding”). The contract segmentation method was the answer devised to control this. After the adoption of this regulation, companies incorporated the establishment of the segment lengths into the policy design process based on the valuation mortality expected to be used. Now it is seen that there are circumstances in which it may be necessary or desirable to change valuation mortality after issue. But if it triggers a segment recalculation then there could be unintended, undesirable results.

This guideline classifies the circumstances involved in changes to valuation mortality rates into two categories: those where deliberately designed postfunding is less likely so no segment recalculation is prescribed, and those where such postfunding is more possible so segment recalculation is required. In general, non-elective valuation mortality changes require no segment recalculation, while elective valuation mortality changes are divided into those on plans filed for approval before the adoption of this guideline and those filed after adoption. To preclude enhancing postfunding by changing valuation mortality after a plan is approved, recalculation of segments is required if the change is elected on plans filed after adoption of this guideline, but is not required for plans filed before.

II. Scope

This guideline is effective December 31, 2008.

III. Text

A. For policies subject to a non-elective change in valuation mortality rates:
For policies which were the subject of a non-elective change in valuation mortality rates because the requirements for continued use of the prior rates were no longer satisfied, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted so that the segments need not be recalculated.

B. For policies subject to a company election to substitute the 2001 Preferred Class Structure Table for the 2001 CSO Mortality Table:

1. For policies issued on a policy form filed for approval prior to January 1, 2009, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted so that the segments need not be recalculated.

2. For policies issued on a policy form filed for approval after January 1, 2009, Section 4B of the Valuation of Life Insurance Policies Model Regulation shall be interpreted to require that the segments be recalculated using the new valuation mortality rates.
APPENDIX TO GUIDELINES

This information can be found at the New York State Insurance Department Web site:
http://www.ins.state.ny.us/life/ilifemax.htm

NEW YORK STATE INSURANCE DEPARTMENT

Maximum Reserve Valuation and Maximum Life Policy
Nonforfeiture Interest Rates

The maximum reserve valuation and nonforfeiture interest rates, prescribed by Sections 4217 and 4221(k) of the New York Insurance Law, are specified in “Table A through Table H Rates” noted below. Such rates vary from year to year based on Moody’s corporate bond yield averages for 12 and 36 months ending on June 30, and weighting factors prescribed by Section 4217. The Moody’s averages are provided for years 1981 to present in the attached Appendix.

Clarification on Fixed Annuity Reserves Interest Rates

We note that there has been some concern over the appropriate maximum valuation interest rate for flexible premium deferred annuities (FPDA). Section 4217(c)(4)(D)(iii) of the New York Insurance Law does not allow the use of the additional .05 weighting factor for annuities that guarantee interest rates on future considerations received more than twelve months beyond the valuation date. Accordingly, for flexible premium deferred annuities the weighting factors shown in Section 4217(c)(4)(D)(iii)(I) or 4217(c)(4)(D)(iii)(II) should be used. For convenience, maximum valuation interest rates for such FPDAs are shown in Table D (issue year basis) and Table G (change in fund basis). The rates shown in Table E and Table H are not appropriate for FPDAs.

- General Information
- Table A through Table H Rates
- Appendix (Moody's Averages)

Regulation 128 and Discontinued 30 year US Treasury Bond

To the extent Regulation 128 references the 30-year spot rate, the spot rate associated with the longest available Treasury bond (e.g., that maturing 2/15/31) should be used.
TO: ALL AUTHORIZED LIFE INSURANCE COMPANIES, ACCREDITED LIFE REINSURERS, FRATERNAL BENEFIT SOCIETIES AND CHARITABLE ANNUITY SOCIETIES

SUBJECT: MAXIMUM RESERVE VALUATION AND MAXIMUM LIFE POLICY NONFORFEITURE INTEREST RATES


The maximum valuation and nonforfeiture interest rates, prescribed by Sections 4217 and 4221(k) of the New York Insurance Law for future years, will vary from year to year depending on Moody’s corporate bond yield averages.

The maximum valuation interest rates for issues, purchases and changes-in-fund of years 1982 through 2010 (and other years where shown) are outlined below. The maximum valuation and nonforfeiture interest rates for Ordinary Life Insurance are shown in Category A, except for Single Premium Life Insurance, as defined in Section 4217(c)(4)(B)(vi), the maximum valuation interest rates for which are shown in Category B.

Please refer to Sections 4217 and 4221 of NY Insurance Law, Regulation 147 and Regulation 151 for definitions and explanations of valuation interest rate, guarantee duration, plan type and product category. Regulation 151 has been effective since February 28, 2001 and is available on our web site.

This notice is to be used for informational purposes, as an aid in complying with the law.
A. ORDINARY LIFE INSURANCE (Except as covered in B)

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Appendix C  Appendix to Guidelines


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### C. Single Premium Immediate Annuities and annuity benefits arising from life insurance policies and annuity and guaranteed interest contracts with cash settlements options.

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© 1999-2011 National Association of Insurance Commissioners
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G. Other Annuities and Guaranteed Interest Contracts, with cash settlement options and with interest rate guarantees on future considerations, valued on the “Change-in-Fund” basis.

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H. Other Annuities and Guaranteed Interest Contracts, with cash settlement options and without interest rate guarantees on future considerations, valued on the “Change-in-Fund” basis.

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### Appendix to Guidelines

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APPENDIX

The maximum reserve valuation interest rates are based on reference interest rates, which are averages of corporate bond earnings published by Moody’s Investors Service, Inc., and weighting factors prescribed by Section 4217, which defines running averages of the published monthly yield rates for 12-month and 36-month periods.

The following table shows the 12-month and 36-month yield averages for recent years:

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<td>5.87</td>
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The maximum nonforfeiture interest rate for Life Insurance, under Section 4221(k), for a particular issue year, is equal to 125% of the maximum reserve valuation interest rate for the same issue year, rounded to the nearer ¼%.

Should the computed maximum reserve valuation interest rate for Life Insurance (other than Single Premium Life Insurance covered in Category B) for a particular issue year be different from the actual maximum reserve valuation interest rate for the next previous issue year by less than ½%, then the maximum reserve valuation interest rate for such particular issue year will be the same as that for such next previous issue year.

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<th>Year</th>
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<th>Next Previous Issue Year</th>
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Appendix D
GAAP Cross-Reference to SAP
As of December 2010

Introduction

As expressed in the Statement of Concepts, Statutory Accounting Principles (SAP) utilizes the framework established by Generally Accepted Accounting Principles (GAAP). Appendix D includes GAAP pronouncements that have been considered or are pending consideration in the development of SAP.

The NAIC Codification of Statutory Accounting Principles by the Statutory Accounting Principles Working Group (SAPWG) (Statutory Accounting Principles as of January 1, 2000) addressed all GAAP pronouncements included in categories a, b, and c issued though 1996, during the initial drafting of the SSAPs, as well as the AICPA Accounting Interpretations included in Category D:

- Category A - FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins
- Category B - FASB Technical Bulletins, Board-Directed FASB Staff Positions, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position
- Category C - Consensus positions of the FASB Emerging Issues Task Force (EITF) and AICPA Practice Bulletins
- Category D - AICPA Accounting Interpretations

Subsequent to the NAIC codification of statutory accounting principles, as documented in the Policy Statement on the Maintenance of Statutory Accounting Principles (included in Appendix F), the SAPWG continued to review new GAAP guidance for applicability to SAP. Beginning January 1, 1999, the NAIC Emerging Accounting Issues Working Group (EAIWG) was formed and began addressing FASB EITF opinions issued subsequent to 1996. The positions of the EAIWG are documented in an interpretation (INT) as indicated by reference in the last column of the GAAP Cross-Reference to SAP chart. Appendix B includes the full text of EAIWG INTs issued through December 2010.

In June 2009, the FASB issued FASB Statement 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (FAS 168), effective for interim and annual periods ending after Sept. 15, 2009. FAS 168 (Topic 105 of the FASB Codification) identified the sources of accounting principles and the framework for selecting the principles used in the preparation of the financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. Pursuant to this standard:

- FASB Accounting Standards Codification was established as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities. (SEC guidance included within the FASB Codification is provided for convenience and relates only to SEC entities.)

- Accounting Standards Updates issued after the effective date of FAS 168 are not considered authoritative in their own right. Such standards serve only to update the FASB Codification, provide background information, and provide the bases of conclusions on the changes to the FASB Codification.

- On the effective date (Sept. 15, 2009), all non-SEC accounting and reporting standards were superseded. Additionally, all nongrandfathered, non-SEC accounting literature not included in the Codification was deemed nonauthoritative.
As a result of FAS 168, Appendix D – GAAP Cross Reference to SAP has been revised to include reference of FASB Accounting Standards Updates, as well as the Accounting Standards Codification Reference (Topic and Subtopic) for pre-codification GAAP guidance. Pre-codification GAAP guidance that has been superseded as a result of exclusion from the GAAP Codification has been identified within Appendix D.

The Statutory Accounting Principles Working Group has formed the Accounting Practices and Procedures Manual Subgroup to assess changes necessary to reflect the new GAAP Codification within statutory accounting principles. Until this process is complete, or as otherwise noted in specific SSAPs or Interpretations, users of the NAIC Accounting Practices and Procedures Manual shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification, or rejected for statutory accounting.

To assist users in tracing pre-codification GAAP standards to the FASB Codification, Appendix D – GAAP Cross-Reference to SAP includes the Topic and Subtopic for all pre-codification GAAP standards that have been included in the FASB Codification. This FASB Codification reference does not reflect GAAP guidance adopted for statutory accounting. Only the guidance detailed in specific SSAPs or Interpretations shall be utilized in determining the GAAP guidance adopted, adopted with modification, or rejected for statutory accounting.

Information Provided in Appendix D – GAAP Cross-Reference to SSAP:

- **Status** - This column includes the SAPWG/EAIWG status of review. A “Pending” status indicates that the SAPWG or EAIWG has not completed deliberation of the GAAP pronouncement. Items noted as “Not Board-Directed or SEC Update” will not be reviewed by the Working Group unless specifically requested for review.

- **Disposition** - This column represents the general conclusion of the SAPWG/EAIWG for the stated GAAP pronouncement. This information is included in Appendix D as a reference tool, however, the guidance in the specific SSAP or Interpretation shall be the authoritative source in determining the GAAP guidance adopted, adopted with modification, or rejected for statutory accounting.

- **SSAP or INT Number** – This column provides the authoritative statutory accounting source addressing the GAAP pronouncement.

- **Accounting Standards Codification Topic and Subtopic** – This column provides a reference guide to trace pre-codification GAAP standards to the new FASB Codification.

In addition to the “GAAP Cross Reference to SSAP,” Appendix D has been expanded to include the “FASB Codification to Pre-Codification GAAP” supplement. This supplement serves as a reference tool in tracing the FASB Codification to pre-codification GAAP standards that have been reviewed, or are pending review as part of the current NAIC statutory accounting maintenance process. This supplement does not indicate which GAAP standards have been adopted, adopted with modification or rejected for statutory accounting. Pre-codification GAAP guidance not captured as part of the statutory accounting maintenance process, but that has been incorporated in the FASB Codification, has not been referenced within this Supplement. Future consideration will occur on whether this pre-codification GAAP guidance will be reviewed for statutory accounting. Pre-codification GAAP included in the FASB codification, but not referenced within this supplement includes: FASB Derivative Implementation Group Issues; EITF Appendix D Topics; FASB Statement No. 138 Examples; FASB Staff Implementation Guides; AICPA Technical Inquiry Service and Audit and Accounting Guides. (The Audit and Accounting Guides (AAG) related to insurance have been reviewed for statutory accounting and are referenced in this supplement –
HCO: Health Care Organizations, LHI: Life and Health Insurance and PLI: Property and Liability Insurance Companies. This supplement also does not include reference to the SEC standards incorporated within the FASB Codification: SEC Financial Reporting Releases; SEC Interpretive Releases; SEC Staff Accounting Bulletins; and SEC Regulation S-X.

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1 To assist users in tracing pre-codification GAAP standards to the FASB Codification, the FASB Codification Topic and Subtopic for all pre-codification GAAP standards has been included in this Appendix. This FASB Codification reference does not reflect GAAP guidance adopted for statutory accounting. The Statutory Accounting Principles Working Group has formed the Accounting Practices and Procedures Manual Subgroup to assess changes necessary to reflect the new GAAP Codification within statutory accounting principles. Until this process is complete, or as otherwise noted in specific SSAPs or Interpretations, users of the NAIC Accounting Practices and Procedures Manual shall continue to refer to the FASB pre-codification standards, and the applicable references to such standards, to determine the GAAP guidance that has been adopted, adopted with modification, or rejected for statutory accounting.
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#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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<td>Accounting by Debtors and Creditors for Troubled Debt Restructurings</td>
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<td>Accounting for Leases: Initial Direct Costs—an amendment of FASB Statement No. 13</td>
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## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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#### FASB STATEMENTS

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<td>FAS 21</td>
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<td>Changes In the Provisions of Lease Agreements Resulting from Refundings of Tax-Exempt Debt—an amendment of FASB Statement No. 13</td>
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<td>FAS 23</td>
<td>Inception of the Lease—an amendment of FASB Statement No. 13</td>
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<td>FAS 24</td>
<td>Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise’s Financial Report—an amendment of FASB Statement No. 14</td>
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<td>Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies—an amendment of FASB Statement No. 19</td>
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<td>Specialized Accounting and Reporting Principles and Practices in AICPA Statements of Position and Guides on Accounting and Auditing Matters—an amendment of APB Opinion No. 20</td>
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<td>Balance Sheet Classification of Deferred Income Taxes—an amendment of APB Opinion No. 11</td>
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## STATUTORY ACCOUNTING PRINCIPLES
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<td>Accounting for Certain Acquisitions of Banking or Thrift Institutions—an amendment of APB Opinion No. 17, an Interpretation of APB Opinions 16 and 17, and an amendment of FASB Interpretation No. 9</td>
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<td>Reporting a Change in Accounting for Railroad Track Structures—an amendment of APB Opinion No. 20</td>
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<td>Accounting for Special Termination Benefits Paid to Employees</td>
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<td>Extinguishment of Debt—an amendment of APB Opinion No. 26</td>
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<td>Reporting by Transferors for Transfers of Receivables with Recourse</td>
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<td>Disclosure of Postretirement Health Care and Life Insurance Benefits</td>
<td>Superseded by FAS 106</td>
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<td>FAS 82</td>
<td>Financial Reporting and Changing Prices: Elimination of Certain Disclosures—an amendment of FASB Statement No. 33</td>
<td>Superseded by FAS 89</td>
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<td>FAS 83</td>
<td>Designation of AICPA Guides and Statement of Position on Accounting by Brokers and Dealers in Securities, by Employee Benefit Plans, and by Banks as Preferable for Purposes of Applying APB Opinion 20—an amendment of FASB Statement No. 32 and APB Opinion No. 30 and a rescission of FASB Interpretation No. 10</td>
<td>Superseded by FAS 111</td>
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<td>FAS 84</td>
<td>Induced Conversions of Convertible Debt—an amendment of APB Opinion No. 26</td>
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## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES
#### PRE-CODIFICATION STANDARDS - CATEGORY A GAAP
#### FASB STATEMENTS

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<td>FAS 85</td>
<td>Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent—an amendment of APB Opinion No. 15</td>
<td>Superseded by FAS 128 Complete</td>
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<td>FAS 86</td>
<td>Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed</td>
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<td>730-10 985-20 985-330 985-705</td>
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<td>Employers’ Accounting for Pensions</td>
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<td>Adopt/M</td>
<td>8, 89</td>
<td>420-10 715-10 715-20 715-30 715-80 805-20 835-20 958-715 960-10 962-10 965-10 980-715</td>
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<td>FAS 88</td>
<td>Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>8, 89</td>
<td>710-10 712-10 715-30 715-60 958-10 958-715</td>
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<td>Adopt provisions that address termination benefits</td>
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<td>Financial Reporting and Changing Prices</td>
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<td>FAS 90</td>
<td>Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs—an amendment of FASB Statement No. 71</td>
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<td>FAS 91</td>
<td>Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases—an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17</td>
<td>Complete</td>
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<td>26, 37, 43R</td>
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<td>FAS 92</td>
<td>Regulated Enterprises—Accounting for Phase-In Plans— an amendment of FASB Statement No. 71</td>
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<td>Recognition of Depreciation by Not-for-Profit Organizations</td>
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<td>FAS 94</td>
<td>Consolidation of All Majority-Owned Subsidiaries—an amendment of ARB No. 51, with related amendments of APB Opinion No. 18 and ARB No. 43, Chapter 12</td>
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<td>FAS 95</td>
<td>Statement of Cash Flows</td>
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<td>230-10 310-10 815-10 830-230 942-230</td>
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<td>FAS 96</td>
<td>Accounting for Income Taxes</td>
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<td>FAS 97</td>
<td>Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments</td>
<td>Complete</td>
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<td>50, 51, 52, 71</td>
<td>944-20 944-30 944-40 944-60 944-605 944-825</td>
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<td>FAS 98</td>
<td>Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases—an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11</td>
<td>Complete</td>
<td>Adopt paragraphs 1-13, 17-22 (a, b, d &amp; e)</td>
<td>Adopt/M paragraphs 22j, 27, 30, and 31</td>
<td>Reject all others</td>
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<td>FAS 99</td>
<td>Deferral of the Effective Date of Recognition of Depreciation by Not-for-Profit Organizations—an amendment of FASB Statement No. 93</td>
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<td>Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96—an amendment of FASB Statement No. 96</td>
<td>Superseded by FAS 103, FAS 108 &amp; FAS 109</td>
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<td>Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71</td>
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<td>Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96—an amendment of FASB Statement No. 96</td>
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<td>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</td>
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<td>Not Directly Included in Codification. Included as amendments to FAS 95</td>
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<td>FAS 107</td>
<td>Disclosures about Fair Value of Financial Instruments</td>
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<td>FAS 110</td>
<td>Reporting by Defined Benefit Pension Plans of Investment Contracts—an amendment of FASB Statement No. 35</td>
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<td>Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts</td>
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<td>61, 62R</td>
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<td>FAS 114</td>
<td>Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No 5 and 15</td>
<td>Complete</td>
<td>Adopt FAS 5 amendments and paragraphs 35 and 36 of CON 6 Adopt paragraphs 9, 22, and 25 Reject paragraphs 6d, 13 &amp; 21 Adopt/M</td>
<td>5R, 36, 37</td>
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<td>Accounting for Certain Investments in Debt and Equity Securities</td>
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<td>Accounting for Contributions Received and Contributions Made</td>
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<td>FAS 117</td>
<td>Statements of Not-for Financial -Profit Organizations</td>
<td>Complete</td>
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<td>954-225, 958-205, 958-210, 958-225, 958-230, 958-320, 958-720</td>
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<td>Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures</td>
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<td>FAS 119</td>
<td>Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments</td>
<td>Superseded by FAS 133</td>
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<td>FAS 120</td>
<td>Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts</td>
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<td>FAS 121</td>
<td>Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of</td>
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### STATUTORY ACCOUNTING PRINCIPLES
**GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES**

**PRE-CODIFICATION STANDARDS - CATEGORY A GAAP FASB STATEMENTS**

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<td>FAS 122</td>
<td>Accounting for Mortgage Servicing Rights</td>
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<td>FAS 123</td>
<td>Accounting for Stock-Based Compensation</td>
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<td>Share-Based Payment</td>
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<td>505-50 718-10 718-20 718-30 715-50 718-740</td>
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<td>FAS 124</td>
<td>Accounting for Certain Investments Held by Not-For-Profit Organizations</td>
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<td>FAS 125</td>
<td>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</td>
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<td>Adopt paragraph 83</td>
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<td>Adopt 9-13 15-17,23-25 27-30,66-71</td>
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<td>FAS 126</td>
<td>Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities</td>
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<td>Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125</td>
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<td>Reporting Comprehensive Income</td>
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<td>Disclosures about Segments of an Enterprise and Related Information</td>
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<td>FAS 132</td>
<td>Employers’ Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106</td>
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<td>Accounting for Derivative Instruments and Hedging Activities</td>
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<td>Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise an amendment of FASB Statement No. 65</td>
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<td>FAS 136</td>
<td>Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others</td>
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<td>N/A</td>
<td>958-20 958-30 958-205 958-225 958-605</td>
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<td>FAS 137</td>
<td>Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133</td>
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<td>Accounting for Certain Derivative Instruments and Certain Hedging Activities – an amendment of FASB Statement No. 133</td>
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<td>FAS 139</td>
<td>Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121</td>
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<td>Not Directly Included in Codification. Included as amendments to FAS 63, FAS 89 and FAS 121</td>
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<td>FAS 140</td>
<td>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, A Replacement of FASB Statement 125</td>
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<td>Adopt/M 91R</td>
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<td>FAS 142</td>
<td>Goodwill and Other Intangible Assets</td>
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<td>205-20 280-10 323-10 350-10 350-20 350-30 730-10</td>
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<td>Accounting for Asset Retirement Obligations</td>
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<td>360-10 410-20 450-20 835-20 840-10 840-40 980-410</td>
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<td>Accounting for the Impairment or Disposal of Long-Lived Assets</td>
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<td>FAS 145</td>
<td>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</td>
<td>Complete</td>
<td>Adopt paragraph 9.c.c Reject all others</td>
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<td>FAS 146</td>
<td>Accounting for Costs Associated with Exit or Disposal Activities</td>
<td>Complete</td>
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<td>280-10 420-10 450-20 712-10 715-30 840-10 912-275 958-225</td>
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<td>FAS 147</td>
<td>Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9</td>
<td>Superseded by FAS 141(R)</td>
<td>Complete</td>
<td>N/A</td>
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<td>FAS 148</td>
<td>Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123</td>
<td>Superseded by FAS 123(R)</td>
<td>Complete</td>
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<td>FAS 149</td>
<td>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</td>
<td>Complete</td>
<td>Paragraphs 4 and 25 adopted. Reject all others.</td>
<td>86</td>
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<td>FAS 150</td>
<td>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</td>
<td>Complete</td>
<td>N/A</td>
<td>260-10 460-10 480-10 835-10</td>
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<td>FAS 151</td>
<td>Inventory Costs—an amendment of ARB No. 43, Chapter 4</td>
<td>Complete</td>
<td>N/A</td>
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<td>FAS 152</td>
<td>Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67</td>
<td>Pending</td>
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<td>FAS 153</td>
<td>Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29</td>
<td>Complete</td>
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<td>FAS 154</td>
<td>Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3</td>
<td>Complete</td>
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<td>Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140</td>
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<td>Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140</td>
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<td>Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</td>
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<td>FAS 159</td>
<td>The Fair Value Option for Financial Assets and Financial Liabilities—including an amendment of FASB Statement No. 115</td>
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<td>470-20, 825-10, 954-825</td>
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<td>FAS 160</td>
<td>Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51</td>
<td>Complete</td>
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<td>FAS 161</td>
<td>Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133</td>
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<td>FAS 162</td>
<td>The Hierarchy of Generally Accepted Accounting Principles</td>
<td>Replaced by FAS 168</td>
<td>Complete</td>
<td>Adopt/M</td>
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<td>FAS 163</td>
<td>Accounting for Financial Guarantee Insurance Contracts—an interpretation of FASB Statement No. 60</td>
<td>Pending</td>
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<td>944-20, 944-40, 944-310, 944-605</td>
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<td>FAS 164</td>
<td>Not-for-Profit Entities: Mergers and Acquisitions—including an amendment of FASB Statement No. 142</td>
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<td>FAS 166</td>
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<td>FAS 167</td>
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<td>FAS 168</td>
<td>The <em>FASB Accounting Standards Codification</em>™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162</td>
<td>Complete</td>
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<td>FIN 01 (APB 20)</td>
<td>Accounting Changes Related to the Cost of Inventory</td>
<td>Complete</td>
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<td>FIN 02 (APB 21)</td>
<td>Imputing Interest on Debt Arrangements Made under the Federal Bankruptcy Act</td>
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<td>FIN 03 (APB 8)</td>
<td>Accounting for the Cost of Pension Plans subject to the Employee Retirement Income Security Act of 1974</td>
<td>Superseded by FAS 87</td>
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<td>FIN 04 (FASB 2)</td>
<td>Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method</td>
<td>Superseded by FAS 141R</td>
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<td>FIN 05 (FASB 2)</td>
<td>Applicability of FASB Statement No. 2 to Development Stage Enterprises</td>
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<td>FIN 06 (FASB 2)</td>
<td>Applicability of FASB Statement No. 2 to Computer Software</td>
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<td>FIN 07 (FASB 7)</td>
<td>Applying FASB Statement No. 7 in Financial Statements of Established Operating Enterprises</td>
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<td>915-10 915-810</td>
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<td>FIN 08 (FASB 6)</td>
<td>Classification of a Short-Term Obligation Repaid Prior to Being Replaced by a Long-Term Security</td>
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<td>FIN 09 (APB 16 &amp; 17)</td>
<td>Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution is Acquired in a Business Combination Accounted for by the Purchase Method</td>
<td>Superseded by FAS 141R</td>
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<td>FIN 10 (FASB 12)</td>
<td>Application of FASB Statement No. 12 to Personal Financial Statements</td>
<td>Superseded by FAS 83</td>
<td>Complete</td>
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<td>FIN 11 (FASB 12)</td>
<td>Changes in Market Value after the Balance Sheet Date</td>
<td>Superseded by FAS 115</td>
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<td>FIN 12 (FASB 12)</td>
<td>Accounting for Previously Established Allowance Accounts</td>
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<td>FIN 13 (FASB 12)</td>
<td>Consolidation of a Parent and Its Subsidiaries Having Different Balance Sheet Dates</td>
<td>Superseded by FAS 115</td>
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<td>FIN 14 (FASB 5)</td>
<td>Reasonable Estimation of the Amount of a Loss</td>
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<td>FIN 15 (FASB 8)</td>
<td>Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company</td>
<td>Superseded by FAS 52</td>
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<td>FIN 16 (FASB 12)</td>
<td>Clarification of Definitions and Accounting for Marketable Equity Securities That Become Nonmarketable</td>
<td>Superseded by FAS 115</td>
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<td>FIN 17 (FASB 8)</td>
<td>Applying the Lower of Cost or Market Rule in Translated Financial Statements</td>
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<td>FIN 18 (APB 28)</td>
<td>Accounting for Income Taxes in Interim Periods</td>
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<td>FIN 19 (FASB 13)</td>
<td>Lessee Guarantee of the Residual Value of Leased Property</td>
<td>Complete</td>
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<td>FIN 20 (APB 20)</td>
<td>Reporting Accounting Changes under AICPA Statements of Position</td>
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<td>FIN 21 (FASB 13)</td>
<td>Accounting for Leases in a Business Combination</td>
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<td>FIN 22 (APB 11 &amp; 23)</td>
<td>Applicability of Indefinite Reversal Criteria to Timing Differences</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
<td>Complete</td>
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<td>FIN 23 (FASB 13)</td>
<td>Leases of Certain Property Owned by a Governmental Unit or Authority</td>
<td>Complete</td>
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<td>FIN 24 (FASB 13)</td>
<td>Leases Involving Only Part of a Building</td>
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<td>FIN 25 (APB 2, 4, 11, &amp; 16)</td>
<td>Accounting for an Unused Investment Tax Credit</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
<td>Complete</td>
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<td>FIN 26 (FASB 13)</td>
<td>Accounting for Purchase of a Leased Asset by the Lessee during the Term of the Lease</td>
<td>Complete</td>
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<td>FIN 27 (FASB 13 &amp; APB 30)</td>
<td>Accounting for a Loss on a Sublease</td>
<td>Complete</td>
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<td>FIN 28 (APB 15 &amp; 25)</td>
<td>Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans</td>
<td>Superseded by FAS 123(R)</td>
<td>Complete</td>
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<td>FIN 29 (APB 23 &amp; 24)</td>
<td>Reporting Tax Benefits Realized on Disposition of Investments in Certain Subsidiaries and Other Investees</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
<td>N/A</td>
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<td>FIN 30 (APB 29)</td>
<td>Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets</td>
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<td>28, 95</td>
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<td>FIN 31 (APB 15 &amp; FASB 28)</td>
<td>Treatment of Stock Compensation Plans in EPS Computations</td>
<td>Superseded by FAS 128</td>
<td>Complete</td>
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<td>FIN 32 (APB 2, 4 &amp; 11)</td>
<td>Application of Percentage Limitations in Recognizing Investment Tax Credit</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
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## PRE-CODIFICATION STANDARDS - CATEGORY A GAAP

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<td><strong>FIN 34</strong> (FASB 5)</td>
<td>Disclosure of Indirect Guarantees of Indebtedness of Others</td>
<td>Superseded by FIN 45</td>
<td>Complete</td>
<td>46, 88, 97</td>
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<td><strong>FIN 35</strong> (APB 18)</td>
<td>Criteria for Applying the Equity Method of Accounting for Investments in Common Stock</td>
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<td>Accounting for Exploratory Wells in Progress at the End of a Period</td>
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<td><strong>FIN 37</strong> (FASB 52)</td>
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<td><strong>FIN 38</strong> (APB 23)</td>
<td>Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock</td>
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<td>Offsetting of Amounts Related to Certain Contracts</td>
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<td><strong>FIN 40</strong> (FASB 12, 60, 97 &amp; 113)</td>
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<td><strong>FIN 41</strong> (APB 10 and FIN 39)</td>
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<td><strong>FIN 42</strong> (FASB 116)</td>
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<td>Superseded by FAS 136</td>
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<td><strong>FIN 43</strong></td>
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<td>FIN 46 (ARB 51)</td>
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## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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<td>Complete</td>
<td>Adopt/M paragraphs 9-15, Reject all others</td>
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<td>APB 3</td>
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<td>Superseded by APB 19</td>
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<td>APB 4</td>
<td>Accounting for the “Investment Credit” (Amending No. 2)</td>
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## STATUTORY ACCOUNTING PRINCIPLES
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## STATUTORY ACCOUNTING PRINCIPLES
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<tr>
<td>ARB 51</td>
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<td>505-10, 810-10, 850-10, 860-10, 958-810, 970-810</td>
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<tr>
<td>TB79-1 (Revised)</td>
<td>Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. No Longer Applicable or Relevant.</td>
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<tr>
<td>TB79-2</td>
<td>Computer Software Costs</td>
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<tr>
<td>TB79-3</td>
<td>Subjective Acceleration Clauses in Long-Term Debt Agreements</td>
<td>Complete</td>
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<td>TB79-4</td>
<td>Segment Reporting of Puerto Rican Operations</td>
<td>Complete</td>
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<tr>
<td>TB79-5</td>
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<td>TB79-6</td>
<td>Valuation Allowances Following Debt Restructuring</td>
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<td>TB79-7</td>
<td>Recoveries of a Previous Writedown under a Troubled Debt Restructuring Involving a Modification of Terms</td>
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<td>Applicability of FASB Statements 21 and 33 to Certain Brokers and Dealers in Securities</td>
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<td>TB79-13</td>
<td>Applicability of FASB Statement No. 13 to Current Value Financial Statements</td>
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<td>TB79-14</td>
<td>Upward Adjustment of Guaranteed Residual Values</td>
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<td>TB79-18</td>
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<td>Adopt</td>
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<td>Not Directly Included in Codification. Included within FAS 109, APB 22 and APB 30</td>
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<tr>
<td>TB82-2</td>
<td>Accounting for the Conversion of Stock Options into Incentive Stock Options as a Result of the Economic Recovery Tax Act of 1981</td>
<td>Superseded by FAS 123 and 123(R)</td>
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<tr>
<td>TB83-1</td>
<td>Accounting for the Reduction in the Tax Basis of an Asset Caused by the Investment Tax Credit</td>
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<td>N/A</td>
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<td>Not Directly Included in Codification. Included within FAS 141R</td>
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<tr>
<td>TB84-2</td>
<td>Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes Relating to Domestic International Sales Corporations</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
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<tr>
<td>TB84-3</td>
<td>Accounting for the Effects of the Tax Reform Act of 1984 on Deferred Income Taxes of Stock Life Insurance Enterprises</td>
<td>Superseded by FAS 96 &amp; FAS 109</td>
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<tr>
<td>TB84-4</td>
<td>In-Substance Defeasance of Debt</td>
<td>Superseded by FAS 125 &amp; FAS 140</td>
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<tr>
<td>TB85-1</td>
<td>Accounting for the Receipt of Federal Home Loan Mortgage Corporation Participating Preferred Stock</td>
<td>Complete</td>
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<td>Not Directly Included in Codification. Included within APB 29</td>
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<td>TB85-2</td>
<td>Accounting for Collateralized Mortgage Obligations (CMOs)</td>
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<td>TB85-3</td>
<td>Accounting for Operating Leases with Scheduled Rent Increases</td>
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<td>TB85-4</td>
<td>Accounting for Purchases of Life Insurance</td>
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<td>Adopt/M</td>
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<td>TB85-5</td>
<td>Issues Relating to Accounting for Business Combinations, Including Costs of Closing Duplicate Facilities of an Acquirer, Stock Transactions between Companies under Common Control, Downstream Mergers, Identical Common Shares for a Pooling of Interests, and Pooling of Interests by Mutual and Cooperative Enterprises</td>
<td>Superseded by FAS 141R</td>
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<td>TB85-6</td>
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<tr>
<td>TB86-2</td>
<td>Accounting for an Interest in the Residual Value of a Leased Asset Acquired by a Third Party or Retained by a Lessor That Sells the Related Minimum Rental Payments</td>
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<tr>
<td>TB87-3</td>
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## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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<td>Complete</td>
<td>Adopt paragraphs 1—12 Reject all others</td>
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<td>TB88-2</td>
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<td>TB94-1</td>
<td>Application of Statement 115 to Debt Securities Restructured in a Troubled Debt Restructuring</td>
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<td>TB01-1</td>
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<td>FSP FAS 106-2</td>
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<td>FSP FAS 115-1 and FAS 124-1</td>
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## GAAP Cross-Reference to SAP

### Appendix D

#### STATUTORY ACCOUNTING PRINCIPLES

**GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES**

**PRE-CODIFICATION STANDARDS - CATEGORY B GAAP**

**FASB STAFF POSITIONS**

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<td>Not Directly Included in Codification. Included within APB 28, FAS 69, FAS 109, FAS 126, FAS 131, FAS 132R and 141R</td>
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<tr>
<td>FSP FAS 129-1</td>
<td>Disclosure Requirements under FASB Statement No. 129 Relating to Contingently Convertible Securities</td>
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<tr>
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<td>FSP FAS 140-1</td>
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<tr>
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**STATUTORY ACCOUNTING PRINCIPLES**

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**PRE-CODIFICATION STANDARDS - CATEGORY B GAAP**

**FASB STAFF POSITIONS**

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On December 5, 2009, the Statutory Accounting Principles Working Group adopted revisions to the NAIC Accounting Practices and Procedures Manual to refer to the FASB Accounting Standards Codification as prescribed in *FAS 168, FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (FAS 168). With the issuance of FAS 168, and the establishment of the FASB Codification, the previous GAAP hierarchy established in *FAS 162, The Hierarchy of Generally Accepted Accounting Principles* (FAS 162) has been eliminated. As a result of FAS 168, the FASB Accounting Standards Codification is the source of authoritative accounting principles recognized by the FASB. (SEC guidance included within the codification is provided for convenience and relates only to SEC entities.) Pursuant to previous decisions by the Statutory Accounting Principles Working Group, FASB Staff Positions (FSPs) issued after May 9, 2008 will be reviewed as part of the statutory accounting maintenance review process. FSPs issued prior to May 9, 2008 will be reviewed as part of the maintenance process if considered to be “Board-directed”. (Board-directed FSPs were issued to provide narrow and limited revisions to the FASB statements or FASB interpretations formerly provided in FASB Technical Bulletins.) FSPs that were not considered ‘Board-directed’ were considered to provide application guidance similar to that found in FASB Staff Implementation Guides and Staff Announcements and were previously classified (pre-FAS 162) as NAIC Level 5 guidance. Due to this Level 5 classification, these FSPs were not reviewed as part of the statutory accounting maintenance review process.
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## STATUTORY ACCOUNTING PRINCIPLES

### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY B GAAP

**AICPA STATEMENTS OF POSITION**

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### STATUTORY ACCOUNTING PRINCIPLES
**GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES**

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<td>99-1</td>
<td>Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of its Corporate Compliance Program</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>99-2</td>
<td>Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans</td>
<td>Complete</td>
<td>N/A</td>
<td>960-20 960-30 960-205 965-10 965-205</td>
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<td>99-3</td>
<td>Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters</td>
<td>Complete</td>
<td>N/A</td>
<td>962-10 962-325 965-325</td>
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<td>00-1</td>
<td>Auditing Health Care Third-Party Revenues and Related Receivables</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>00-2</td>
<td>Accounting by Producers or Distributors of Films</td>
<td>Complete</td>
<td>N/A</td>
<td>926-10 926-20 926-230 926-330 926-405 926-430 926-605 926-720 926-835 926-845 926-855</td>
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<td>00-3</td>
<td>Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts</td>
<td>Pending</td>
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<td>944-805</td>
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<td>01-1</td>
<td>Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Directly Included in Codification. Included within SOP 95-2</td>
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<td>01-2</td>
<td>Accounting and Reporting by Health and Welfare Benefit Plans</td>
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<td>N/A</td>
<td>Not Directly Included in Codification. Included within EBP AAG and SOP 92-6</td>
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<td>01-3</td>
<td>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>SSAP or INT Number</td>
<td>Acctg. Stds. Codification Topic-Subt.</td>
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<td>01-4</td>
<td>Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards</td>
<td>Withdrawn</td>
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<td>Complete</td>
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<td></td>
<td>Not Directly Included in Codification. Included within SOP 94-5</td>
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<td>01-5</td>
<td>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</td>
<td>Complete</td>
<td>Adopt</td>
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<td>01-6</td>
<td>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</td>
<td>Complete</td>
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<td>N/A</td>
<td>310-10 310-20 460-10 605-20 825-10 835-30 860-20 860-50 942-10 942-210 942-305 942-310 942-320 942-325 942-360 942-405 942-470 942-505 942-825 944-320 944-320 948-10</td>
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<td>02-1</td>
<td>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Payment Reports as Required by the New Jersey Administrative Code</td>
<td>Complete</td>
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<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>02-2</td>
<td>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</td>
<td>Complete</td>
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<td>N/A</td>
<td>954-815</td>
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<td>03-1</td>
<td>Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts</td>
<td>Complete</td>
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<td>56</td>
<td>944-20 944-30 944-40 944-80 944-320 944-605</td>
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<td>03-2</td>
<td>Attest Engagements on Greenhouse Gas Emissions Information</td>
<td>Complete</td>
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<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>03-3</td>
<td>Accounting for Certain Loans or Debt Securities Acquired in a Transfer</td>
<td>Considered for 43R only</td>
<td>Paragraphs 5, 7 and 9 adopted for 43R only.</td>
<td>43R</td>
<td>310-10 310-30 835-10</td>
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<td>03-4</td>
<td>Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Directly Included in Codification. Included within SOP 95-2</td>
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<td>03-5</td>
<td>Financial Highlights of Separate Accounts: An Amendment to the Audit and Accounting Guide Audits of Investment Companies</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Directly Included in Codification. Included within INV AAG</td>
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<td>04-1</td>
<td>Auditing the Statement of Social Insurance</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>05-1</td>
<td>Statement of Position 05-1 Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts</td>
<td>Pending</td>
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<td>944-30</td>
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<td>06-1</td>
<td>Statement of Position 06-1 Reporting Pursuant to the Global Investment Performance Standards</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>07-1</td>
<td>Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies</td>
<td>Complete</td>
<td>N/A</td>
<td>946-10 946-323 946-810</td>
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<td>07-2</td>
<td>Attestation Engagements That Address Specified Compliance of Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers</td>
<td>Complete</td>
<td>N/A</td>
<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>09-1</td>
<td>Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data</td>
<td>Pending</td>
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<td>Not Included in Codification. Auditing and Attestation SOP</td>
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<td>84-1</td>
<td>1984 Tax Reform Act: Deferred Income Taxes of Stock Life Insurance Companies</td>
<td>Resolved by FAS 109</td>
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<td>84-3</td>
<td>Convertible Debt “Sweeteners”</td>
<td>Nullified by FAS 84</td>
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<td>84-4</td>
<td>Acquisition, Development and Construction Loans</td>
<td>Resolved by PB 1</td>
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<td>810-10</td>
<td>815-15</td>
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<td>84-5</td>
<td>Sale of Marketable Securities with a Put Option</td>
<td>Complete Reject</td>
<td>18, 91R</td>
<td>460-10</td>
<td>860-10 860-20</td>
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<td>84-6</td>
<td>Termination of Defined Benefit Pension Plans</td>
<td>Nullified by FAS 88</td>
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<td>84-7</td>
<td>Termination of Interest Rate Swaps</td>
<td>Partially nullified and Partially resolved by FAS 133</td>
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<td>84-8</td>
<td>Variable Stock Purchase Warrants Given by Suppliers to Customers</td>
<td>Resolved by FAS 123(R)</td>
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<td>84-9</td>
<td>Deposit Float of Banks</td>
<td>Superseded by PB 1 and AAG BSI</td>
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<td>84-10</td>
<td>LIFO Conformity of Companies Relying on Insilco Tax Court Decision</td>
<td>No EITF Consensus</td>
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<td>84-11</td>
<td>Offsetting Installment Note Receivables and Bank Debt (“Note Monetization”)</td>
<td>Resolved by FIN 39</td>
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<td>84-12</td>
<td>Operating Leases with Scheduled Rent Increases</td>
<td>Nullified by FTB 85-3</td>
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<td>84-13</td>
<td>Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
<td>Adopt</td>
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<td>84-14</td>
<td>Deferred Interest Rate Setting</td>
<td>Nullified by FAS 133</td>
<td>Complete</td>
<td>Reject</td>
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<td>84-15</td>
<td>Grantor Trusts Consolidation</td>
<td>No EITF Consensus</td>
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<td>84-16</td>
<td>Earnings-per-Share Cash-Yield Test for Zero Coupon Bonds</td>
<td>Resolved by FAS 85</td>
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<td>84-17</td>
<td>Profit Recognition on Sales of Real Estate with Graduated Payment Mortgages</td>
<td>Complete</td>
<td>Adopt</td>
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<td>84-18</td>
<td>Stock Option Pyramiding</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
<td>Adopt</td>
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<td>84-19</td>
<td>Mortgage Loan Payment Modifications</td>
<td>Complete</td>
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<td>310-20</td>
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<td>84-20</td>
<td>GNMA Dollar Rolls</td>
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<td>Adopt</td>
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<td>815-10 860-10</td>
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<td>84-21</td>
<td>Sale of a Loan with a Partial Participation Retained</td>
<td>Resolved by FAS 125 &amp; FAS 140</td>
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<td>84-22</td>
<td>Prior Years' Earnings per Share following a Savings and Loan Association Conversion and Pooling</td>
<td>Resolved by FAS 141</td>
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<td>84-23</td>
<td>Leveraged Buyout Holding Company Debt</td>
<td>No EITF Consensus</td>
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<td>84-24</td>
<td>LIFO Accounting Issues</td>
<td>No EITF Consensus</td>
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<td>84-25</td>
<td>Offsetting Nonrecourse Debt with Sales-Type of Direct Financing Lease Receivables</td>
<td>Resolved by FTB 86-2</td>
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<td>84-26</td>
<td>Deceasance of Special-Purpose Borrowings</td>
<td>Resolved by FAS 125 &amp; FAS 140</td>
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<td>84-27</td>
<td>Deferred Taxes on Subsidiary Stock Sales</td>
<td>Resolved by FAS 109</td>
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<td>84-28</td>
<td>Impairment of Long-Lived Assets</td>
<td>Resolved by FAS 121 and FAS 144</td>
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<td>84-29</td>
<td>Gain and Loss Recognition on Exchanges of Productive Assets and the Effect of Boot</td>
<td>Resolved by EITF 86-29</td>
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<td>84-30</td>
<td>Sales of Loans to Special-Purpose Entities</td>
<td>Resolved by FIN 46 &amp; FIN 46 (R)</td>
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<td>84-31</td>
<td>Equity Certificates of Deposit</td>
<td>Resolved by FAS 133</td>
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<td>84-32</td>
<td>(Not Used)</td>
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<td>84-33</td>
<td>Acquisition of a Tax Loss Carryforward—Temporary Parent-Subsidiary Relationship</td>
<td>Resolved by FAS 144</td>
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<td>84-34</td>
<td>Permanent Discount Restricted Stock Purchase Plans</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
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<td>84-35</td>
<td>Business Combinations: Sale of Duplicate Facilities and Accrual of Liabilities</td>
<td>No EITF Consensus</td>
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<td>84-36</td>
<td>Interest Rate Swap Transactions</td>
<td>Nullified by FAS 133 Complete</td>
<td>Adopt 31</td>
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<td>84-37</td>
<td>Sale-Leaseback Transaction with Repurchase Option</td>
<td>No EITF Consensus</td>
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<td>840-40</td>
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<td>84-38</td>
<td>Identical Common Shares for a Pooling of Interests</td>
<td>Nullified by FTB 85-5</td>
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<td>84-39</td>
<td>Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control</td>
<td>No longer technically helpful</td>
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<td>84-40</td>
<td>Long-Term Debt Repayable by a Capital Stock Transaction</td>
<td>Nullified by FIN 46, FIN 46 (R) &amp; FAS 150</td>
<td>Complete</td>
<td>Reject</td>
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<td>84-41</td>
<td>Consolidation of Subsidiary after Instantaneous In-Substance Defeasance</td>
<td>Resolved by FAS 94</td>
<td>Reject</td>
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<td>84-42</td>
<td>Push-Down of Parent Company Debt to a Subsidiary</td>
<td>No EITF Consensus</td>
<td>Reject</td>
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<td>84-43</td>
<td>Income Taxes Effects of Asset Revaluations in Certain Foreign Countries</td>
<td>Nullified by FAS 109</td>
<td>Reject</td>
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<td>84-44</td>
<td>Partial Termination of a Defined Benefit Pension Plan</td>
<td>Resolved by FAS 88</td>
<td>Reject</td>
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<td>85-1</td>
<td>Classifying Notes Received for Capital Stock</td>
<td>Complete</td>
<td>Reject</td>
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<td>310-10 505-10 850-10</td>
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<td>85-2</td>
<td>Classification of Costs Incurred in a Takeover Defense</td>
<td>Nullified by TB 85-6</td>
<td>Complete</td>
<td>Reject</td>
<td>72</td>
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<td>85-3</td>
<td>Tax Benefits Relating to Asset Dispositions Following an Acquisition of a Financial Institution</td>
<td>Nullified by FAS 109</td>
<td>Complete</td>
<td>Reject</td>
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<td>85-4</td>
<td>Downstream Mergers and Other Stock Transactions between Companies under Common Control</td>
<td>Resolved by FTB 85-5</td>
<td>Reject</td>
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<td>85-5</td>
<td>Restoration of Deferred Taxes Previously Eliminated by Net Operating Loss Recognition</td>
<td>Resolved by FAS 109</td>
<td>Reject</td>
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<td>85-6</td>
<td>Futures Implementation Questions</td>
<td>Resolved by Q&amp;A 80</td>
<td>Reject</td>
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<td>85-7</td>
<td>Federal Home Loan Mortgage Corporation Stock</td>
<td>Resolved by FTB 85-1</td>
<td>Reject</td>
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<td>85-8</td>
<td>Amortization of Thrift Intangibles</td>
<td>Nullified by FAS 141(R)</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>85-9</td>
<td>Revenue Recognition on Options to Purchase Stock of Another Entity</td>
<td>Complete</td>
<td>Adopt</td>
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<td>470-20</td>
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<td>85-10</td>
<td>Employee Stock Ownership Plan Contribution Funded by a Pension Plan Termination</td>
<td>Nullified by FAS 88</td>
<td>Reject</td>
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<tr>
<td>85-11</td>
<td>Use of an Employee Stock Ownership Plan in a Leveraged Buyout</td>
<td>No longer technically helpful</td>
<td>Reject</td>
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<tr>
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<td>85-12</td>
<td>Retention of Specialized Accounting for Investments in Consolidation</td>
<td>Complete</td>
<td>N/A</td>
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<td>810-10</td>
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<td>85-13</td>
<td>Sale of Mortgage Service Rights on Mortgages Owned by Others</td>
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<td>85-14</td>
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<td>85-15</td>
<td>Recognizing Benefits of Purchased Net Operating Loss Carryforwards</td>
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<td>Complete</td>
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</table>
| 85-16               | Leveraged Leases  
- Real Estate Leases and Sale-Leaseback Transactions  
- Delayed Equity Contributions by Lessors | Complete | Adopt | 22 | 840-30 |
<p>| 85-17               | Accrued Interest upon Conversion of Convertible Debt | Complete | Adopt | 15 | 470-20 835-10 |
| 85-18               | Earnings-per-Share Effect of Equity Commitment Notes | Partially Nullified by FAS 128 | Complete | N/A | INT 99-00 | Not Directly Included in Codification. Included within FAS 128 |
| 85-19               | (Not Used) | Complete | N/A | INT 99-00 | |
| 85-20               | Recognition of Fees for Guaranteeing a Loan | Complete | Adopt | 27 | 310-10 460-10 605-20 |
| 85-21               | Changes of Ownership Resulting in a New Basis of Accounting | No EITF Consensus | | | 805-50 |
| 85-22               | Retroactive Application of FASB Technical Bulletins | No longer technically helpful | | | |
| 85-23               | Effect of a Redemption Agreement on Carrying Value of a Security | Complete | N/A | INT 99-00 | Not Directly Included in Codification. Issue Subject to FAS 133 |
| 85-24               | Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge | Complete | N/A | INT 99-00 | 946-605 |
| 85-25               | Sale of Preferred Stocks with a Put Option | Nullified by FAS 125, 133 &amp; 140 | Complete | N/A | INT 99-00 | 460-10 860-20 |</p>
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<td>85-27</td>
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<td>Complete</td>
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<td>Not Directly Included in Codification. Issue Subject to FAS 133, FAS 155 and FIN 45</td>
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<td>85-31</td>
<td>Comptroller of the Currency’s Rule on Deferred Tax Debits</td>
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<td>N/A</td>
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<td>85-32</td>
<td>Purchased Lease Residuals</td>
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<td>85-36</td>
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<td>85-37</td>
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<td>85-39</td>
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<td>85-40</td>
<td>Comprehensive Review of Sales of Marketable Securities with Put Arrangements</td>
<td>Nullified by FAS 125 and partially nullified by FAS 140</td>
<td>N/A</td>
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<td>85-41</td>
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<td>Not Included in Codification As No Longer Applicable Or Relevant</td>
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<td>85-45</td>
<td>Business Combinations: Settlement of Stock Options and Awards</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
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<td>Retroactive Wage Adjustments Affecting Medicare Payments</td>
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<td>Income Statement Treatment of Income Tax Benefit for Employee Stock Ownership Plan Dividends</td>
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<td>INT 99-00 470-10</td>
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<td>86-5</td>
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<td>86-7</td>
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<td>Sale of Bad-Debt Recovery Rights</td>
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<td>86-9</td>
<td>IRC Section 338 and Push-Down Accounting</td>
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<td>86-10</td>
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<tr>
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<td>Accounting by Insureds for Claims-Made Insurance Policies</td>
<td>Codified in Issue 03-8</td>
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<td>86-13</td>
<td>Recognition of Inventory Market Declines at Interim Reporting Dates</td>
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<td>Purchased Research and Development Projects in a Business Combination</td>
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<td>86-15</td>
<td>Increasing-Rate Debt</td>
<td>Complete</td>
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<td>86-16</td>
<td>Carryover of Predecessor Cost in Leveraged Buyout Transactions</td>
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<td>86-17</td>
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<td>Complete</td>
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<td>460-10 840-40</td>
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<td>86-18</td>
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<td>Resolved by FIN 39 and Superseded by Issue 96-19</td>
<td>Complete</td>
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# STATUTORY ACCOUNTING PRINCIPLES
## GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES
### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP
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<td>Complete</td>
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<td>86-24</td>
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<td>86-25</td>
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<td>86-26</td>
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### STATUTORY ACCOUNTING PRINCIPLES
#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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<td>87-4</td>
<td>Restructuring of Operations: Implications of SEC Staff Accounting Bulletin No. 67</td>
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<td>87-5</td>
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<td>87-6</td>
<td>Adjustments Relating to Stock Compensation Plans</td>
<td>Nullified by FIN 44</td>
<td>Complete</td>
<td>Adopt</td>
<td>13</td>
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<tr>
<td>87-7</td>
<td>Sale of an Asset Subject to a Lease and Nonrecourse Financing: “Wrap-Lease Transactions”</td>
<td>Complete</td>
<td>Reject</td>
<td>22</td>
<td>Not Directly Included in Codification. Issue Subject to EITF 88-1 and FAS 13</td>
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<tr>
<td>87-9</td>
<td>Profit Recognition on Sales of Real Estate with Insured Mortgages or Surety Bonds</td>
<td>Complete</td>
<td>Adopt</td>
<td>40</td>
<td>360-20</td>
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<tr>
<td>87-10</td>
<td>Revenue Recognition by Television (Barter) Syndicators</td>
<td>Guidance revised by FAS 139</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<tr>
<td>87-11</td>
<td>Allocation of Purchase Price to Assets to Be Sold</td>
<td>Nullified by FAS 144</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>87-12</td>
<td>Foreign Debt-for-Equity Swaps</td>
<td>Complete</td>
<td>Reject</td>
<td>23</td>
<td>830-20</td>
</tr>
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</table>
## Appendix D  GAAP Cross-Reference to SAP

### STATUTORY ACCOUNTING PRINCIPLES
**GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES**

**PRE-CODIFICATION STANDARDS - CATEGORY C GAAP**
**CONSSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

<table>
<thead>
<tr>
<th>GAAP Pronouncement</th>
<th>Name</th>
<th>Status</th>
<th>Disposition</th>
<th>SSAP or INT Number</th>
<th>Acctg. Stds. Codification Topic-Subt.</th>
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<tbody>
<tr>
<td>87-13</td>
<td>Amortization of Prior Service Cost for a Defined Benefit Plan When There Is a History of Plan Amendments</td>
<td>Resolved by Q&amp;A 87, Question 20</td>
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<td>87-14</td>
<td>(Not Used)</td>
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<td>87-15</td>
<td>Effect of a Standstill Agreement on Pooling-of-Interests Accounting</td>
<td>Nullified by FAS 141</td>
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<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>87-16</td>
<td>Whether the 90 Percent Test for a Pooling of Interests is Applied Separately to Each Company or on a Combined Basis</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>87-17</td>
<td>Spinoffs or Other Distributions of Loans Receivable to Shareholders</td>
<td>Codified in EITF 01-2</td>
<td>Complete</td>
<td>N/A</td>
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<tr>
<td>87-18</td>
<td>Use of Zero Coupon Bonds in a Troubled Debt Restructuring</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>36</td>
<td>310-40</td>
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<tr>
<td>87-19</td>
<td>Substituted Debtors in a Troubled Debt Restructuring</td>
<td>Complete</td>
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<td>310-40</td>
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<tr>
<td>87-20</td>
<td>Offsetting Certificates of Deposit against High-Coupon Debt</td>
<td>Partially resolved by FAS 125 and Superseded by EITF 96-19</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<tr>
<td>87-21</td>
<td>Change of Accounting Basis in Master Limited Partnership Transactions</td>
<td>Complete</td>
<td>Reject</td>
<td>46, 88, 97</td>
<td>805-50</td>
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<tr>
<td>87-22</td>
<td>Prepayments to the Secondary Reserve of the FSLIC</td>
<td>Issue Addressed in PB 3 and PB 3 was Withdrawn Complete</td>
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<td>INT 99-00</td>
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<td>Status</td>
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<td>87-23</td>
<td>Book Value Stock Purchase Plans</td>
<td>Issues 1 and 2 nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R) and Issue 3 nullified by SOP 93-6</td>
<td>Complete</td>
<td>Adopt</td>
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<td>87-24</td>
<td>Allocation of Interest to Discontinued Operations</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>205-20</td>
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<tr>
<td>87-25</td>
<td>Sale of Convertible, Adjustable-Rate Mortgages with Contingent Repayment Agreement</td>
<td>Resolved by FAS 125 &amp; FAS 140</td>
<td>Complete</td>
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<td>87-26</td>
<td>Hedging of Foreign Currency Exposure with a Tandem Currency</td>
<td>Nullified by FAS 133</td>
<td>Complete</td>
<td>Reject</td>
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<tr>
<td>87-27</td>
<td>Poolings of Companies That Do Not Have a Controlling Class of Common Stock</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
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<tr>
<td>87-28</td>
<td>Provision for Deferred Taxes on Increases in Cash Surrender Value of Key-Person Life Insurance</td>
<td>Resolved by FAS 109</td>
<td>Complete</td>
<td>N/A</td>
<td>860-10</td>
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<tr>
<td>87-29</td>
<td>Exchange of Real Estate Involving Boot</td>
<td>Codified in EITF 01-2</td>
<td>Complete</td>
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<td>87-30</td>
<td>Sale of a Short-Term Loan Made under a Long-Term Credit Commitment</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>860-10</td>
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<td>87-31</td>
<td>Sale of Put Options on Issuer’s Stock</td>
<td>Codified in EITF No. 96-13</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
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<td>87-32</td>
<td>(Not Used)</td>
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<td>87-33</td>
<td>Stock Compensation Issues Related to Market Decline</td>
<td>Nullified by FIN 44</td>
<td>Complete</td>
<td>Adopt</td>
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<tr>
<td>87-34</td>
<td>Sale of Mortgage Servicing Rights with a Subservicing Agreement</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
<td>860-50</td>
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<td>GAAP Pronouncement</td>
<td>Name</td>
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<td>88-1</td>
<td>Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan</td>
<td>Complete</td>
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<td>8, 89</td>
<td>715-20, 715-30</td>
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<td>88-3</td>
<td>Rental Concessions Provided by Landlord</td>
<td>Resolved by FTB 88-1 and EITF 88-10 and 94-3</td>
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<td>88-4</td>
<td>Classification of Payment Made to IRS to Retain Fiscal Year</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>740-10</td>
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<td>88-5</td>
<td>Recognition of Insurance Death Benefits</td>
<td>Complete</td>
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<td>325-30</td>
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<td>88-6</td>
<td>Book Value Stock Plans in an Initial Public Offering</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
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<td>88-8</td>
<td>Mortgage Swaps</td>
<td>Partially nullified and partially resolved by FAS 133</td>
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<td>88-9</td>
<td>Put Warrants</td>
<td>Nullified by FAS 128, 133, and 150 or superseded by Issue No. 96-13</td>
<td>Complete</td>
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<td>88-10</td>
<td>Costs Associated with Lease Modification or Termination</td>
<td>Nullified and resolved by FAS 146</td>
<td>Complete</td>
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<td>GAAP Pronouncement</td>
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<td>Disposition</td>
<td>SSAP or INT Number</td>
<td>Acctg. Std. Codification Topic-Subt.</td>
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<td>88-11</td>
<td>Allocation of Recorded Investment When a Loan or Part of a Loan Is Sold</td>
<td>Nullified by Statement 125 and Statement 140, as amended by Statement 156</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
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<tr>
<td>88-12</td>
<td>Transfer of Ownership Interest as Part of Down Payment under FASB Statement No. 66</td>
<td>Complete</td>
<td>Adopt</td>
<td>40</td>
<td>360-20</td>
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<tr>
<td>88-13</td>
<td>(Not Used)</td>
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<td>88-14</td>
<td>Settlement of Fees with Extra Units to a General Partner in a Master Limited Partnership</td>
<td>No EITF Consensus</td>
<td>Complete</td>
<td>Adopt</td>
<td>470-10 810-10</td>
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<tr>
<td>88-15</td>
<td>Classification of Subsidiary’s Loan Payable in Consolidated Balance Sheet When Subsidiary’s and Parent’s Fiscal Years Differ</td>
<td>No EITF Consensus</td>
<td>Complete</td>
<td>Reject</td>
<td>22 840-40</td>
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<tr>
<td>88-16</td>
<td>Basis in Leveraged Buyout Transactions</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>88-17</td>
<td>Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations</td>
<td>Partially nullified by FAS 125 &amp; superseded by EITF 97-3</td>
<td>Complete</td>
<td>Reject</td>
<td>37</td>
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<tr>
<td>88-18</td>
<td>Sales of Future Revenues</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
<td>470-10</td>
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<tr>
<td>88-19</td>
<td>FSLIC-Assisted Acquisitions of Thrifts</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>942-10</td>
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<tr>
<td>88-20</td>
<td>Difference between Initial Investment and Principal Amount of Loans in a Purchased Credit Card Portfolio</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>88-21</td>
<td>Accounting for the Sale of Property Subject to the Seller’s Preexisting Lease</td>
<td>Complete</td>
<td>Reject</td>
<td>22</td>
<td>840-40</td>
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<tr>
<td>88-22</td>
<td>Securitization of Credit Card and Other Receivable Portfolios</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
<td>860-10 860-20</td>
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<tr>
<td>88-23</td>
<td>Lump-Sum Payments under Union Contracts</td>
<td>Complete</td>
<td>Reject</td>
<td>29</td>
<td>710-10</td>
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<tr>
<td>88-24</td>
<td>Effect of Various Forms of Financing under FASB Statement No. 66</td>
<td>Complete</td>
<td>Adopt</td>
<td>40</td>
<td>360-20</td>
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<tr>
<td>88-25</td>
<td>Ongoing Accounting and Reporting for a Newly Created Liquidating Bank</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>852-10 942-810</td>
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</table>
# STATUTORY ACCOUNTING PRINCIPLES

## GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

#### CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

<table>
<thead>
<tr>
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<th>Status</th>
<th>Disposition</th>
<th>SSAP or INT Number</th>
<th>Acctg. Stds. Codification Topic-Subt.</th>
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<tbody>
<tr>
<td>88-26</td>
<td>Controlling Preferred Stock in a Pooling of Interests</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>88-27</td>
<td>Effect of Unallocated Shares in an Employee Stock Ownership Plan on Accounting for Business Combinations</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>89-1</td>
<td>Accounting by a Pension Plan for Bank Investment Contracts and Guaranteed Investment Contracts</td>
<td>Resolved by FAS 110 and SOP 94-4</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>89-2</td>
<td>Maximum Maturity Guarantees on Transfers of Receivables with Recourse</td>
<td>Nullified by FAS 125 &amp; partially nullified by FAS 140</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>89-3</td>
<td>Balance Sheet Presentation of Savings Accounts in Financial Statements of Credit Unions</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>942-405</td>
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<tr>
<td>89-4</td>
<td>Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate</td>
<td>Superseded by EITF 99-20</td>
<td>Complete</td>
<td>Reject</td>
<td>43R</td>
</tr>
<tr>
<td>89-5</td>
<td>Sale of Mortgage Loan Servicing Rights</td>
<td>Superseded by EITF 95-5</td>
<td>Complete</td>
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<td>43R</td>
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<td>89-6</td>
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<td>89-7</td>
<td>Exchange of Assets or Interest in a Subsidiary for a Noncontrolling Equity Interest in a New Entity</td>
<td>Codified in EITF 01-2</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>89-8</td>
<td>Expense Recognition for Employee Stock Ownership Plans</td>
<td>Nullified by SOP 93-6</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>89-9</td>
<td>Accounting for In-Substance Foreclosures</td>
<td>Nullified by FAS 114</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
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<tr>
<td>89-10</td>
<td>Sponsor’s Recognition of Employee Stock Ownership Plan Debt</td>
<td>Superseded by SOP 93-6</td>
<td>Complete</td>
<td>Reject</td>
<td>480-10</td>
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<td>89-11</td>
<td>Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan</td>
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<td>Reject</td>
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<td>480-10</td>
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<tr>
<td>89-12</td>
<td>Earnings-per-Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan</td>
<td>Superseded by SOP 93-6</td>
<td>Complete</td>
<td>Reject</td>
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<tr>
<td>89-13</td>
<td>Accounting for the Cost of Asbestos Removal</td>
<td>Complete</td>
<td>Adopt</td>
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<td>410-20 410-30</td>
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</table>

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### STATUTORY ACCOUNTING PRINCIPLES

#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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<th>Name</th>
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<th>SSAP or INT Number</th>
<th>Acctg. Stds. Codification Topic-Subt.</th>
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<td>89-14</td>
<td>Valuation of Repossessed Real Estate</td>
<td>Complete</td>
<td>Adopt</td>
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<td>310-40</td>
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<td>89-15</td>
<td><strong>Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties</strong></td>
<td>Superseded by EITF 02-4</td>
<td>Complete</td>
<td>Adopt/M</td>
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<td>89-16</td>
<td>Consideration of Executory Costs in Sale-Leaseback Transactions</td>
<td>Complete</td>
<td>Reject</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>89-17</td>
<td><strong>Accounting for the Retail Sale of an Extended Warranty Contract in Connection with the Sale of a Product</strong></td>
<td>Nullified by FTB 90-1</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>89-18</td>
<td><strong>Divestitures of Certain Investment Securities to an Unregulated Commonly Controlled Entity under FIRREA</strong></td>
<td>Nullified by FAS 115</td>
<td>Complete</td>
<td>N/A</td>
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<td>89-19</td>
<td><strong>Accounting for a Change in Goodwill Amortization for Business Combinations Initiated Prior to the Effective Date of FASB Statement No. 72</strong></td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
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<td>89-20</td>
<td>Accounting for Cross Border Tax Benefit Leases</td>
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<td>N/A</td>
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<td>90-2</td>
<td><strong>Exchange of Interest-Only and Principal-Only Securities for a Mortgage-Backed Security</strong></td>
<td>Nullified by FAS 125 and FAS 140</td>
<td>Complete</td>
<td>Adopt</td>
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<td>90-3</td>
<td>Accounting for Employers’ Obligations for Future Contributions to a Multiemployer Pension Plan</td>
<td>Complete</td>
<td>Adopt</td>
<td>8, 89</td>
<td>715-80</td>
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<td>90-4</td>
<td>Earnings-per-Share Treatment of Tax Benefits for Dividends on Stock Held by an Employee Stock Ownership Plan</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>718-40</td>
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<tr>
<td>90-5</td>
<td><strong>Exchanges of Ownership Interests between Entities under Common Control</strong></td>
<td>Nullified by FAS 141R and FAS 160</td>
<td>Complete</td>
<td>Reject</td>
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<tr>
<td>90-6</td>
<td><strong>Accounting for Certain Events Not Addressed in Issue No. 87-11 Relating to an Acquired Operating Unit to Be Sold</strong></td>
<td>Nullified by FAS 144</td>
<td>Complete</td>
<td>Reject</td>
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</table>
### STATUTORY ACCOUNTING PRINCIPLES
#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**CONSSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

<table>
<thead>
<tr>
<th>GAAP Pronouncement</th>
<th>Name</th>
<th>Status</th>
<th>Disposition</th>
<th>SSAP or INT Number</th>
<th>Acctg. Stds. Codification Topic-Subt.</th>
</tr>
</thead>
<tbody>
<tr>
<td>90-7</td>
<td>Accounting for a Reload Stock Option</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
<td>Adopt</td>
<td>13</td>
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<tr>
<td>90-8</td>
<td>Capitalization of Costs to Treat Environmental Contamination</td>
<td>Complete</td>
<td>Adopt</td>
<td>40</td>
<td>410-20 410-30</td>
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<tr>
<td>90-9</td>
<td>Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring</td>
<td>Nullified by FIN 44</td>
<td>Complete</td>
<td>Adopt</td>
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<tr>
<td>90-10</td>
<td>Accounting for a Business Combination Involving a Majority-Owned Investee of a Venture Capital Company</td>
<td>Resolved by FAS 141</td>
<td>Complete</td>
<td>Adopt</td>
<td>13</td>
</tr>
<tr>
<td>90-11</td>
<td>Accounting for Exit and Entrance Fees Incurred in a Conversion from the Savings Association Insurance Fund to the Bank Insurance Fund</td>
<td>No longer technically helpful</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>90-12</td>
<td>Allocating Basis to Individual Assets and Liabilities for Transactions within the Scope of Issue No. 88-16</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>90-13</td>
<td>Accounting for Simultaneous Common Control Mergers</td>
<td>Nullified by FAS 141R and FAS 160</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>90-14</td>
<td>Unsecured Guarantee by Parent of Subsidiary’s Lease Payments in a Sale-Leaseback Transaction</td>
<td>Complete</td>
<td>Adopt</td>
<td>22</td>
<td>460-10 840-40</td>
</tr>
<tr>
<td>90-15</td>
<td>Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions</td>
<td>Nullified by FIN 46 &amp; FIN 46 (R)</td>
<td>Complete</td>
<td>Reject</td>
<td>22</td>
</tr>
<tr>
<td>90-16</td>
<td>Accounting for Discontinued Operations Subsequently Retained</td>
<td>Nullified by FAS 144</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>GAAP Pronouncement</td>
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<tr>
<td>90-17</td>
<td><em>Hedging Foreign Currency Risks with Purchased Options</em></td>
<td>Affirmed by FAS 133; therefore no longer necessary</td>
<td>Complete</td>
<td>Reject</td>
<td>31</td>
</tr>
<tr>
<td>90-18</td>
<td>Effect of a “Removal of Accounts” Provision on the Accounting for a Credit Card Securitization</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>Not Directly Included in Codification. Issue Subject to FAS 140 and FAS 156</td>
</tr>
<tr>
<td>90-19</td>
<td><em>Convertible Bonds with Issuer Option to Settle for Cash upon Conversion</em></td>
<td>Nullified by FSP APB 14-1</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>260-10 470-20 815-15</td>
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<tr>
<td>90-20</td>
<td>Impact of an Uncollateralized Irrevocable Letter of Credit on a Real Estate Sale-Leaseback Transaction</td>
<td>Complete</td>
<td>Adopt</td>
<td>22</td>
<td>460-10 840-40</td>
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<tr>
<td>90-21</td>
<td>Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
<td>460-10 860-10 860-50</td>
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<tr>
<td>90-22</td>
<td>Accounting for Gas-Balancing Arrangements</td>
<td>No EITF Consensus</td>
<td>Complete</td>
<td>932-10</td>
<td>932-815</td>
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<tr>
<td>91-1</td>
<td><em>Hedging Intercompany Foreign Currency Risks</em></td>
<td>Nullified by FAS 133</td>
<td>Complete</td>
<td>Reject</td>
<td>31</td>
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<tr>
<td>91-2</td>
<td>Debtor’s Accounting for Forfeiture of Real Estate Subject to a Nonrecourse Mortgage</td>
<td>No EITF Consensus</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>91-3</td>
<td><em>Accounting for Income Tax Benefits from Bad Debts of a Savings and Loan Association</em></td>
<td>Resolved by FAS 109</td>
<td>Complete</td>
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<td>325-20</td>
</tr>
<tr>
<td>91-4</td>
<td><em>Hedging Foreign Currency Risks with Complex Options and Similar Transactions</em></td>
<td>Resolved by FAS 133</td>
<td>Complete</td>
<td>Reject</td>
<td>31</td>
</tr>
<tr>
<td>91-5</td>
<td>Nonmonetary Exchange of Cost-Method Investments</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
<td>440-10 980-605</td>
</tr>
<tr>
<td>91-6</td>
<td>Revenue Recognition of Long-Term Power Sales Contracts</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>715-30</td>
</tr>
<tr>
<td>91-7</td>
<td>Accounting for Pension Benefits Paid by Employers after Insurance Companies Fail to Provide Annuity Benefits</td>
<td>Complete</td>
<td>Adopt</td>
<td>8, 89</td>
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<tr>
<td>GAAP Pronouncement</td>
<td>Name</td>
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<tr>
<td>91-8</td>
<td>Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10</td>
</tr>
<tr>
<td>91-9</td>
<td>Revenue and Expense Recognition for Freight Services in Process</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>605-20</td>
</tr>
<tr>
<td>91-10</td>
<td>Accounting for Special Assessments and Tax Increment Financing Entities (TIFEs)</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>460-10 970-470</td>
</tr>
<tr>
<td>92-1</td>
<td>Allocation of Residual Value or First-Loss Guarantee to Minimum Lease Payments in Leases Involving Land and Building(s)</td>
<td>Complete</td>
<td>Reject</td>
<td>22</td>
<td>460-10 840-10</td>
</tr>
<tr>
<td>92-2</td>
<td>Measuring Loss Accruals by Transferors for Transfers of Receivables with Recourse</td>
<td>Complete</td>
<td>Reject</td>
<td>18, 91R</td>
<td>Not Directly Included in Codification. Issue Subject to FAS 133, FAS 140, FAS 156 and FIN 45.</td>
</tr>
<tr>
<td>92-3</td>
<td>Earnings-per-Share Treatment of Tax Benefits for Dividends on Unallocated Stock Held by an Employee Stock Ownership Plan (Consideration of the Implications of FASB Statement No. 109 on Issue 2 of EITF Issue No. 90-4)</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>Not Directly Included in Codification. Issue Subject to SOP 93-6</td>
</tr>
<tr>
<td>92-4</td>
<td>Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary</td>
<td>Complete</td>
<td>Reject</td>
<td>23</td>
<td>830-10</td>
</tr>
<tr>
<td>92-5</td>
<td>Amortization Period for Net Deferred Credit Card Origination Costs</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>310-20</td>
</tr>
<tr>
<td>92-6</td>
<td>(Not Used)</td>
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<tr>
<td>92-7</td>
<td>Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>980-605</td>
</tr>
<tr>
<td>92-8</td>
<td>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</td>
<td>Complete</td>
<td>Adopt</td>
<td>10R</td>
<td>830-740</td>
</tr>
<tr>
<td>92-9</td>
<td>Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
<td>944-20</td>
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<tr>
<td>92-10</td>
<td>Loan Acquisitions Involving Table Funding Arrangements</td>
<td>Nullified by FAS 125</td>
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<tr>
<td>92-11</td>
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<tr>
<td>92-12</td>
<td>Accounting for OPEB Costs by Rate-Regulated Enterprises</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>715-60 980-715</td>
</tr>
<tr>
<td>92-13</td>
<td>Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>450-20 715-60 930-715</td>
</tr>
</tbody>
</table>
## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES
#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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<tbody>
<tr>
<td>93-1</td>
<td>Accounting for Individual Credit Card Acquisitions</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>310-20</td>
</tr>
<tr>
<td>93-2</td>
<td>Effect of Acquisition of Employer Shares for/by an Employee Benefit Trust on Accounting for Business Combinations</td>
<td>Resolved by FAS 141</td>
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<tr>
<td>93-3</td>
<td>Plan Assets under FASB Statement No. 106</td>
<td>Complete</td>
<td>Adopt</td>
<td>14</td>
<td>710-10 715-60</td>
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<tr>
<td>93-4</td>
<td>Accounting for Regulatory Assets</td>
<td>Nullified by FAS 121 &amp; FAS 144</td>
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<td>980-340 980-715</td>
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<tr>
<td>93-5</td>
<td>Accounting for Environmental Liabilities</td>
<td>Nullified by SOP 96-1</td>
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<tr>
<td>93-6</td>
<td>Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>62R</td>
<td>944-20</td>
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<tr>
<td>93-7</td>
<td>Uncertainties Related to Income Taxes in a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>93-8</td>
<td>Accounting for the Sale and Leaseback of an Asset That is Leased to Another Party</td>
<td>Complete</td>
<td>Adopt</td>
<td>22</td>
<td>840-40</td>
</tr>
<tr>
<td>93-9</td>
<td>Application of FASB Statement No. 109 in Foreign Financial Statements Restated for General Price-Level Changes</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>830-740</td>
</tr>
<tr>
<td>93-10</td>
<td>Accounting for Dual Currency Bonds</td>
<td>Resolved by FAS 133</td>
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<tr>
<td>93-11</td>
<td>Accounting for Barter Transactions Involving Barter Credits</td>
<td>Complete</td>
<td>Adopt</td>
<td>28, 95</td>
<td>845-10</td>
</tr>
<tr>
<td>93-12</td>
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<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>Not Directly Included in Codification. Included in FAS 109</td>
</tr>
<tr>
<td>93-13</td>
<td>Effect of a Retroactive Change in Enacted Tax Rates That is Included in Income from Continuing Operations</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10</td>
</tr>
<tr>
<td>93-14</td>
<td>Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises</td>
<td>Complete</td>
<td>Reject</td>
<td>66</td>
<td>720-20 944-20 450-10</td>
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<td>93-15</td>
<td>(Not Used)</td>
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<tr>
<td>93-16</td>
<td>Application of FASB Statement No. 109 to Basis Differences within Foreign Subsidiaries That Meet the Indefinite Reversal Criterion of APB Opinion No. 23</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-30 830-740</td>
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<tr>
<td>GAAP Pronouncement</td>
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<tr>
<td>93-17</td>
<td>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</td>
<td>Complete</td>
<td>Adopt</td>
<td>10R</td>
<td>740-30</td>
</tr>
<tr>
<td>93-18</td>
<td>Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate</td>
<td>Superseded by EITF 99-20</td>
<td>Reject</td>
<td>43R</td>
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<tr>
<td>94-1</td>
<td>Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>93</td>
<td>323-740 325-20</td>
</tr>
<tr>
<td>94-2</td>
<td>Treatment of Minority Interests in Certain Real Estate Investment</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>974-810</td>
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<tr>
<td>94-3</td>
<td>Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)</td>
<td>Nullified by FAS 146</td>
<td>Complete</td>
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<tr>
<td>94-4</td>
<td>Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity</td>
<td>Resolved by FAS 125 &amp; FAS 140</td>
<td>Reject</td>
<td>24</td>
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<tr>
<td>94-5</td>
<td>Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue 89-5</td>
<td>Superseded by EITF 95-5</td>
<td>Complete</td>
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<tr>
<td>94-6</td>
<td>Accounting for the Buyout of Compensatory Stock Options</td>
<td>Nullified by FIN 44</td>
<td>Complete</td>
<td>Adopt</td>
<td>13</td>
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<tr>
<td>94-7</td>
<td>Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock</td>
<td>Codified in EITF 96-13</td>
<td>Complete</td>
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<tr>
<td>94-8</td>
<td>Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring</td>
<td>Complete</td>
<td>Reject</td>
<td>36</td>
<td>310-40</td>
</tr>
<tr>
<td>94-9</td>
<td>Determining a Normal Servicing Fee Rate for the Sale of an SBA Loan</td>
<td>Nullified by FAS 125</td>
<td>Complete</td>
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<tr>
<td>94-10</td>
<td>Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10 740-20</td>
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<tr>
<td>95-1</td>
<td>Revenue Recognition on Sales with a Guaranteed Minimum Resale Value</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>460-10 605-50 840-10 840-30</td>
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<tr>
<td>95-2</td>
<td>Determination of What Constitutes a Firm Commitment for Foreign Currency Transactions Not Involving a Third Party</td>
<td>Nullified by FAS 133</td>
<td>Complete</td>
<td>Reject</td>
<td>23</td>
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<td>95-3</td>
<td>Recognition of Liabilities in Connection with a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete Reject</td>
<td>68</td>
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<tr>
<td>95-4</td>
<td>Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>605-15 840-10</td>
</tr>
<tr>
<td>95-5</td>
<td>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</td>
<td>Complete</td>
<td>Adopt</td>
<td>18, 91R</td>
<td>860-50</td>
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<tr>
<td>95-6</td>
<td>Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>974-323 974-840</td>
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<td>95-7</td>
<td>Implementation Issues Related to the Treatment of Minority Interests in Certain Real Estate Investment Trusts</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<td>95-8</td>
<td>Accounting for Contingent Consideration Paid to the Shareholders of an Acquired Enterprise in a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete Reject</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>95-9</td>
<td>Accounting for Tax Effects of Dividends in France in Accordance with FAS Statement No. 109</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10</td>
</tr>
<tr>
<td>95-10</td>
<td>Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109</td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10</td>
</tr>
<tr>
<td>95-11</td>
<td>Accounting for Derivative Instruments Containing Both a Written Option-Based Component and a Forward-Based Component</td>
<td>Resolved by FAS 133</td>
<td>Complete</td>
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<tr>
<td>95-12</td>
<td>Pooling of Interests with a Common Interest in Joint Venture</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>95-14</td>
<td>Recognition of Liabilities in Anticipation of a Business Combination</td>
<td>Nullified by FAS 146</td>
<td>Complete Reject</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>95-15</td>
<td>Recognition of Gain or Loss When a Binding Contract Requires a Debt Extinguishment to Occur at a Future Date for a Specified Amount</td>
<td>Superseded by EITF 96-19</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>15</td>
</tr>
</tbody>
</table>
### STATUTORY ACCOUNTING PRINCIPLES

#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

<table>
<thead>
<tr>
<th>GAAP Pronouncement</th>
<th>Name</th>
<th>Status</th>
<th>Disposition</th>
<th>SSAP or INT Number</th>
<th>Acctg. Stds. Codification Topic-Subt.</th>
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<tbody>
<tr>
<td>95-16</td>
<td><strong>Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25</strong></td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
<td>Adopt</td>
<td>13</td>
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<tr>
<td>95-17</td>
<td><strong>Accounting for Modifications to an Operating Lease That Do Not Change the Lease Classification</strong></td>
<td>Complete</td>
<td>Adopt</td>
<td>22</td>
<td>840-20</td>
</tr>
<tr>
<td>95-18</td>
<td><strong>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.</strong></td>
<td>Nullified by FAS 144</td>
<td>Complete</td>
<td>Reject</td>
<td>24</td>
</tr>
<tr>
<td>95-19</td>
<td><strong>Determination of the Measurement Date for the Market Price of Securities Issued in a Purchase Business Combination</strong></td>
<td>Codified in EITF 99-12</td>
<td>Complete</td>
<td>Adopt</td>
<td>68</td>
</tr>
<tr>
<td>95-20</td>
<td><strong>Measurement in the Consolidated Financial Statements of a Parent of the Tax Effects Related to the Operations of a Foreign Subsidiary That Receives Tax Credits Related to Dividend Payments</strong></td>
<td>Complete</td>
<td>Reject</td>
<td>10R</td>
<td>740-10</td>
</tr>
<tr>
<td>95-21</td>
<td><strong>Accounting for Assets to Be Disposed Of Acquired in a Purchase Business Combination</strong></td>
<td>Resolved by FAS 144</td>
<td>Complete</td>
<td>N/A</td>
<td>470-10</td>
</tr>
<tr>
<td>95-22</td>
<td><strong>Balance Sheet Classification of Borrowings Outstanding under Revolving Credit Agreements That Include both a Subjective Acceleration Clause and a Lock-Box Arrangement</strong></td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>470-10</td>
</tr>
<tr>
<td>95-23</td>
<td><strong>The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment</strong></td>
<td>Complete</td>
<td>Adopt</td>
<td>40</td>
<td>360-10 360-20</td>
</tr>
<tr>
<td>96-1</td>
<td><strong>Sale of Put Options on Issuer’s Stock That Require or Permit Cash Settlement</strong></td>
<td>Codified in EITF 96-13</td>
<td>Complete</td>
<td>N/A</td>
<td>96-13</td>
</tr>
<tr>
<td>96-2</td>
<td><strong>Impairment Recognition When a Nonmonetary Asset Is Exchanged or Is Distributed to Owners and Is Accounted for at the Asset’s Recorded Amount</strong></td>
<td>Codified in EITF 01-2</td>
<td>Complete</td>
<td>N/A</td>
<td>96-2</td>
</tr>
</tbody>
</table>
# STATUTORY ACCOUNTING PRINCIPLES

## GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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<tbody>
<tr>
<td>96-3</td>
<td>Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services under FASB Statement No. 123</td>
<td>Superseded by EITF 96-18</td>
<td>Complete</td>
<td>Reject</td>
<td>13</td>
</tr>
<tr>
<td>96-4</td>
<td>Accounting for Reorganizations Involving a Non-Pro Rata Split-off of Certain Nonmonetary Assets to Owners</td>
<td>Codified in EITF 01-2</td>
<td>Complete</td>
<td>Reject</td>
<td>28, 95</td>
</tr>
<tr>
<td>96-5</td>
<td>Recognition of Liabilities for Contractual Termination Benefits or Changing Benefit Plan Assumptions in Anticipation of a Business Combination</td>
<td>Complete</td>
<td>Adopt</td>
<td></td>
<td>8, 89, 420-10, 450-10, 710-10, 712-10, 715-60, 718-10, 805-20</td>
</tr>
<tr>
<td>96-6</td>
<td>Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products</td>
<td>No EITF Consensus</td>
<td></td>
<td></td>
<td>985-705</td>
</tr>
<tr>
<td>96-7</td>
<td>Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>96-8</td>
<td>Accounting for a Business Combination When the Issuing Company Has Targeted Stock</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>Reject</td>
<td>68</td>
</tr>
<tr>
<td>96-9</td>
<td>Classification of Inventory Markdowns and Other Costs Associated with a Restructuring</td>
<td>Removed from EITF Agenda</td>
<td></td>
<td></td>
<td>330-10, 420-10</td>
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<tr>
<td>96-10</td>
<td>Impact of Certain Transactions on the Held-to-Maturity Classification under FASB Statement No. 115</td>
<td>Complete</td>
<td>Reject</td>
<td>26</td>
<td>320-10</td>
</tr>
<tr>
<td>96-11</td>
<td>Accounting for Forward Contracts and Purchased Options to Acquire Securities Covered by FASB Statement No. 115</td>
<td>Complete</td>
<td>Reject</td>
<td>31</td>
<td>320-10, 815-10</td>
</tr>
<tr>
<td>96-12</td>
<td>Recognition of Interest Income and Balance Sheet Classification of Structured Notes</td>
<td>Complete</td>
<td>Reject</td>
<td>43R</td>
<td>320-10, 835-10</td>
</tr>
<tr>
<td>96-13</td>
<td>Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock</td>
<td>Codified in EITF 00-19</td>
<td>Complete</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>96-14</td>
<td>Accounting for the Costs Associated with Modifying Computer Software for the Year 2000</td>
<td>No longer technically helpful</td>
<td>Complete</td>
<td>Adopt</td>
<td>17</td>
</tr>
</tbody>
</table>
## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

**PRE-CODIFICATION STANDARDS - CATEGORY C GAAP**
**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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</tr>
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<tbody>
<tr>
<td>96-15</td>
<td>Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities</td>
<td>Complete</td>
<td>Reject</td>
<td>23</td>
<td>320-10 830-20</td>
</tr>
<tr>
<td>96-16</td>
<td>Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>810-10</td>
</tr>
<tr>
<td>96-17</td>
<td>Revenue Recognition under Long-Term Power Sales Contracts That Contain both Fixed and Variable Pricing Terms</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>980-350 980-605</td>
</tr>
<tr>
<td>96-18</td>
<td>Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>440-10 505-50</td>
</tr>
<tr>
<td>96-19</td>
<td>Debtor’s Accounting for a Modification or Exchange of Debt Instruments</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-14</td>
<td>470-50</td>
</tr>
<tr>
<td>96-20</td>
<td>Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities</td>
<td>Nullified by FAS 140</td>
<td>Complete</td>
<td>Reject</td>
<td>18</td>
</tr>
<tr>
<td>96-21</td>
<td>Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities</td>
<td>Complete</td>
<td>Reject</td>
<td>22</td>
<td>460-10 840-10 840-20 840-40 958-810 958-840</td>
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<tr>
<td>96-22</td>
<td>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</td>
<td>Complete</td>
<td>Adopt</td>
<td>36</td>
<td>310-40</td>
</tr>
<tr>
<td>96-23</td>
<td>The Effects of Financial Instruments Indexed to, and Settled in, a Company’s Own Stock on Pooling-of-Interests Accounting for a Subsequent Business Combination</td>
<td>Resolved by FAS 141</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>97-1</td>
<td>Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>450-20 460-10 840-10 840-40 958-840</td>
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<tr>
<td>GAAP Pronouncement</td>
<td>Name</td>
<td>Status</td>
<td>Disposition</td>
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<tr>
<td>97-2</td>
<td>Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>718-10 810-10 954-810</td>
</tr>
<tr>
<td>97-3</td>
<td>Accounting for Fees and Costs Associated with Loan Syndications and Loan Participations after the Issuance of FASB Statement No. 125</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>310-20 860-10</td>
</tr>
<tr>
<td>97-4</td>
<td>Deregulation of the Pricing of Electricity---Issues Related to the Application of FASB Statements No. 71 and 101</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>980-20</td>
</tr>
<tr>
<td>97-5</td>
<td>Accounting for the Delayed Receipt of Option Shares upon Exercise under APB Opinion No. 25</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
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<tr>
<td>97-6</td>
<td>Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125</td>
<td>Nullified by FAS 140</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
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<tr>
<td>97-7</td>
<td>Accounting for Hedges of the Foreign Currency Risk Inherent in an Available-for-Sale Marketable Equity Security</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>Not Directly Included in Codification. Issue Subject to FAS 130 and 133</td>
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<tr>
<td>97-8</td>
<td>Accounting for Contingent Consideration Issued in a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-10</td>
</tr>
<tr>
<td>97-9</td>
<td>Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments</td>
<td>Nullified by FAS 141</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>97-10</td>
<td>The Effect of Lessee Involvement in Asset Construction</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>460-10 840-40</td>
</tr>
<tr>
<td>97-11</td>
<td>Accounting for Internal Costs Relating to Real Estate Property Acquisitions</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-16</td>
<td>970-340 970-720</td>
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<tr>
<td>97-12</td>
<td>Accounting for Increased Share Authorizations in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25</td>
<td>Nullified by FAS 123(R) except for entities within the scope of paragraph 83 of FAS 123(R)</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-17</td>
</tr>
<tr>
<td>97-13</td>
<td>Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-18</td>
<td>720-45</td>
</tr>
<tr>
<td>97-14</td>
<td>Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>INT 00-06</td>
<td>260-10 710-10 810-10</td>
</tr>
<tr>
<td>97-15</td>
<td>Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>98-1</td>
<td>Valuation of Debt Assumed in a Purchase Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
<td>98-2</td>
<td>Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 01-07</td>
<td>Not Directly Included in Codification. Issue Subject to FIN 46R</td>
</tr>
<tr>
<td>98-3</td>
<td>Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or a Business</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>INT 00-26</td>
</tr>
<tr>
<td>98-4</td>
<td>Accounting by a Joint Venture for Businesses Received at Its Formation</td>
<td>No EITF Consensus</td>
<td>Complete</td>
<td>No EITF Consensus</td>
<td>805-10 845-10</td>
</tr>
<tr>
<td>98-5</td>
<td>Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 00-08</td>
<td>470-20 505-10</td>
</tr>
<tr>
<td>98-6</td>
<td>Investor's Accounting for an Investment in a Limited Partnership When the Investor Is the Sole General Partner and the Limited Partners Have Certain Approval or Veto Rights</td>
<td>Removed from EITF Agenda</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 00-08</td>
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<tr>
<td>98-7</td>
<td>Accounting for Exchanges of Similar Equity Method Investments</td>
<td>Codified in EITF 01-2</td>
<td>Adopt</td>
<td>INT 99-21</td>
<td>360-20</td>
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<tr>
<td>98-8</td>
<td>Accounting for Transfers of Investments That Are in Substance Real Estate</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 99-22</td>
<td>450-20 450-30 840-10</td>
</tr>
<tr>
<td>98-9</td>
<td>Accounting for Contingent Rent</td>
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<td>Adopt/M</td>
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</tr>
<tr>
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<td>Accounting for Contracts Involved in Energy Trading and Risk Management Activities</td>
<td>Superseded by EITF 02-3</td>
<td>Adopt/M</td>
<td>86</td>
<td>740-10</td>
</tr>
<tr>
<td>98-11</td>
<td>Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations</td>
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<td>INT 00-24</td>
<td>323-10</td>
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<tr>
<td>98-12</td>
<td>Application of Issue No. 00-19 to Forward Equity Sales Transactions</td>
<td>Nullified by FAS 150</td>
<td>Adopt/M</td>
<td>86</td>
<td>740-10</td>
</tr>
<tr>
<td>98-13</td>
<td>Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>INT 00-24</td>
<td>323-10</td>
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<tr>
<td>98-14</td>
<td>Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 00-10</td>
<td>470-50</td>
</tr>
<tr>
<td>98-15</td>
<td>Structured Notes Acquired for a Specified Investment Strategy</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 00-11</td>
<td>320-10</td>
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<tr>
<td>99-1</td>
<td>Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary</td>
<td>Superseded by EITF 08-8</td>
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<td>470-20</td>
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<tr>
<td>99-2</td>
<td>Accounting for Weather Derivatives</td>
<td>Complete</td>
<td>Adopt/M</td>
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<td>460-10 815-45</td>
</tr>
<tr>
<td>99-3</td>
<td>Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives</td>
<td>Codified in EITF 00-19</td>
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<td>470-20</td>
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<tr>
<td>99-4</td>
<td>Accounting for Stock Received from the Demutualization of a Mutual Insurance Company</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 00-12</td>
<td>325-30</td>
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<td>99-5</td>
<td>Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>340-10 460-10 730-10</td>
</tr>
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### GAAP Cross-Reference to SAP

#### STATUTORY ACCOUNTING PRINCIPLES

#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

#### CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE

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</thead>
<tbody>
<tr>
<td>99-6</td>
<td>Impact of Acceleration Provisions in Grants Made between Initiation and Consummation of a Pooling-of-Interests Business Combination</td>
<td>Complete</td>
<td>Nullified by FAS 141</td>
<td>N/A</td>
<td>INT 99-00</td>
</tr>
<tr>
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<td>Determining the Classification and Benefit Attribution Method for a &quot;Cash Balance&quot; Pension Plan</td>
<td>Complete</td>
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<td>INT 04-12</td>
<td>715-30</td>
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<td>03-5</td>
<td>Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software</td>
<td>Complete</td>
<td>Adopt</td>
<td>INT 04-13</td>
<td>985-605</td>
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<td>03-6</td>
<td>Participating Securities and the Two-Class Method under FASB Statement No. 128</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>260-10</td>
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<td>03-7</td>
<td>Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)</td>
<td>Nullified by FSP APB 14-1</td>
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<td>INT 04-15</td>
<td>470-20</td>
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<td>03-8</td>
<td>Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity</td>
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<td>450-30 720-20 954-720</td>
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<td>03-9</td>
<td>Determination of the Useful Life of Renewable Intangible Assets Under FASB Statement No. 142</td>
<td>Removed from EITF agenda</td>
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<td>03-10</td>
<td>Application of Issue No. 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>605-50</td>
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<tr>
<td>03-11</td>
<td>Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not &quot;Held for Trading Purposes&quot; as Defined in Issue No. 02-3</td>
<td>Complete</td>
<td>Reject</td>
<td>INT 99-00</td>
<td>815-10</td>
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<td>03-12</td>
<td>Impact of FASB Interpretation No. 45 on Issue No. 95-1</td>
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<td>03-13</td>
<td>Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations</td>
<td>Complete</td>
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<td>03-14</td>
<td>Participants' Accounting for Emissions Allowances under a &quot;Cap and Trade&quot; Program</td>
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<td>03-15</td>
<td>Interpretation of Constraining Conditions of a Transferee in a Collateralized Bond Obligation Structure</td>
<td>No EITF Consensus</td>
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<td>03-16</td>
<td>Accounting for Investments in Limited Liability Companies</td>
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<td>272-10 323-30</td>
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<td>03-17</td>
<td>Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet</td>
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### STATUTORY ACCOUNTING PRINCIPLES

**GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES**

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<tr>
<td>04-1</td>
<td>Accounting for Preexisting Relationships between the Parties to a Business Combination</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
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<td>04-2</td>
<td>Whether Mineral Rights Are Tangible or Intangible Assets</td>
<td>Nullified by FAS 141R</td>
<td>Complete</td>
<td>N/A</td>
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<tr>
<td>04-3</td>
<td>Mining Assets: Impairment and Business Combinations</td>
<td>Complete</td>
<td>N/A</td>
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<td>930-360 930-805</td>
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<tr>
<td>04-4</td>
<td>Allocation of Goodwill to Reporting Units for a Mining Enterprise</td>
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<td>04-5</td>
<td>Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights</td>
<td>Complete</td>
<td>N/A</td>
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<td>04-6</td>
<td>Accounting for Stripping Costs Incurred during Production in the Mining Industry</td>
<td>Complete</td>
<td>N/A</td>
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<td>930-10 930-330</td>
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<tr>
<td>04-7</td>
<td>Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity</td>
<td>Removed From Agenda – Issue Addressed in FSP FIN 46R-6</td>
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<td>04-8</td>
<td>The Effect of Contingently Convertible Instruments on Diluted Earnings per Share</td>
<td>Complete</td>
<td>N/A</td>
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<td>04-9</td>
<td>Accounting for Suspended Well Costs</td>
<td>Resolved by FSP FAS 19-1</td>
<td>Complete</td>
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<td>04-10</td>
<td>Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds</td>
<td>Complete</td>
<td>N/A</td>
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<td>04-11</td>
<td>Accounting in a Business Combination for Deferred Postcontract Customer Support Revenue of a Software Vendor</td>
<td>No longer technically helpful</td>
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<td>04-12</td>
<td>Determining Whether Equity-Based Compensation Awards Are Participating Securities</td>
<td>Removed from EITF agenda</td>
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<tr>
<td>04-13</td>
<td>Accounting for Purchases and Sales of Inventory with the Same Counterparty</td>
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<td>N/A</td>
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### STATUTORY ACCOUNTING PRINCIPLES
#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

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**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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<th>Name</th>
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<tr>
<td>05-1</td>
<td>Accounting for the Conversion of an Instrument That Became Convertible upon the Issuer's Exercise of a Call Option</td>
<td>Pending</td>
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<tr>
<td>05-2</td>
<td>The Meaning of &quot;Conventional Convertible Debt Instrument&quot; in Issue No. 00-19</td>
<td>Pending</td>
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<tr>
<td>05-3</td>
<td>Accounting for Rental Costs Incurred during the Construction Period</td>
<td>Removed from EITF agenda</td>
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<tr>
<td>05-4</td>
<td>The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to Issue No. 00-19</td>
<td>Removed from EITF agenda</td>
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<tr>
<td>05-5</td>
<td>Accounting for Early Retirement or Postemployment Programs with Specific Features (Such As Terms Specified in Altersteilzeit Early Retirement Arrangements)</td>
<td>Complete N/A</td>
<td>INT 99-00</td>
<td>715-30</td>
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<tr>
<td>05-6</td>
<td>Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination</td>
<td>Complete N/A</td>
<td>INT 06-10</td>
<td>805-20 840-10</td>
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</tr>
<tr>
<td>05-7</td>
<td>Accounting for Modifications to Conversion Options Embedded in Debt Instruments and Related Issues</td>
<td>Superseded by EITF Issue No. 06-6</td>
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<td>05-8</td>
<td>Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature</td>
<td>Complete N/A</td>
<td>INT 99-00</td>
<td>740-10</td>
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<tr>
<td>06-1</td>
<td>Accounting for Consideration Given by a Service Provider to a Manufacturer or Reseller of Equipment Necessary for an End-Customer to Receive Service from the Service Provider</td>
<td>Complete N/A</td>
<td>INT 99-00</td>
<td>605-50</td>
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<td>06-2</td>
<td>Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43</td>
<td>Pending</td>
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<td>06-3</td>
<td>How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)</td>
<td>Complete Adopt/M</td>
<td>INT 07-03</td>
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<tr>
<td>06-4</td>
<td>Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements</td>
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<tr>
<td>06-5</td>
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<td>21</td>
<td>325-30</td>
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<tr>
<td>06-6</td>
<td>Debtor's Accounting for a Modification (or Exchange) of Convertible Debt Instruments</td>
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### STATUTORY ACCOUNTING PRINCIPLES
#### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

**PRE-CODIFICATION STANDARDS - CATEGORY C GAAP**

**CONSENSUS OPINIONS OF THE EMERGING ISSUES TASK FORCE**

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<tr>
<td>06-7</td>
<td>Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133</td>
<td>Complete</td>
<td>N/A</td>
<td>INT 99-00</td>
<td>470-20 815-15</td>
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<tr>
<td>06-8</td>
<td>Applicability of the Assessment of a Buyer's Continuing Investment under FASB Statement No. 66 for Sales of Condominiums</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>INT 08-02</td>
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<tr>
<td>06-9</td>
<td>Reporting a Change in (or the Elimination of) a Previously Existing Difference between the Fiscal Year-End of a Parent Company and That of a Consolidated Entity or between the Reporting Period of an Investor and That of an Equity Method Investee</td>
<td>Complete</td>
<td>Adopt/M</td>
<td>INT 08-03</td>
<td>810-10</td>
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<tr>
<td>06-10</td>
<td>Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements</td>
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<td>06-11</td>
<td>Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards</td>
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<td>06-12</td>
<td>Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, Brokers and Dealers in Securities</td>
<td>No EITF Consensus</td>
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<td>07-1</td>
<td>Accounting for Collaborative Arrangements</td>
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<td>07-2</td>
<td>Accounting for Convertible Debt Instruments That Are Not Subject to the Guidance in Paragraph 12 of APB Opinion No. 14</td>
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<tr>
<td>07-3</td>
<td>Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities</td>
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<td>INT 08-04</td>
<td>730-10 730-20</td>
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<td>07-4</td>
<td>Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships</td>
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<tr>
<td>07-5</td>
<td>Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock</td>
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<td>718-10 815-10 815-40</td>
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<td>07-6</td>
<td>Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66, When the Agreement Includes a Buy-Sell Clause</td>
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<td>INT 08-07</td>
<td>360-20</td>
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<tr>
<td>08-1</td>
<td>Revenue Recognition for a Single Unit of Accounting (The name of EITF 08-1 has been changed to “Revenue Arrangements with Multiple Deliverables.”)</td>
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<td>Lessor Revenue Recognition for Maintenance Services</td>
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<td>08-3</td>
<td>Accounting by Lessees for Maintenance Deposits</td>
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<tr>
<td>08-4</td>
<td>Transition Guidance for Conforming Changes to Issue No. 98-5</td>
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<td>08-5</td>
<td>Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement</td>
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<td>08-6</td>
<td>Equity Method Investment Accounting Considerations</td>
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<td>Accounting for Defensive Intangible Assets</td>
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<tr>
<td>08-8</td>
<td>Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary</td>
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<td>08-10</td>
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<td>09-1</td>
<td>Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance</td>
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<td>09-2</td>
<td>Research and Development Assets Acquired in an Asset Acquisition</td>
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<td>09-3</td>
<td>Applicability of AICPA Statement of Position 97-2 to Certain Arrangements That Include Software Elements</td>
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<td>Seller Accounting for Contingent Consideration</td>
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Note: “EITF Abstracts, Appendix D - Other Technical Matters” have been included in the FASB Codification, but have not previously been reviewed for statutory accounting. As such, these items have not been included in this Appendix D. Before the FASB Codification, these items were not considered to be in the top three levels of the FASB hierarchy and, thus, not reviewed as part of the statutory maintenance process.
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<td>PB 1</td>
<td>Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance</td>
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<td>PB 2</td>
<td>Elimination of Profits Resulting From Intercompany Transfers of LIFO Inventories</td>
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<tr>
<td>PB 3</td>
<td>Prepayments Into the Secondary Reserve of the FSLIC and Contingencies Related to Other Obligations of the FSLIC</td>
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<tr>
<td>PB 4</td>
<td>Accounting for Foreign Debt/Equity Swaps</td>
<td>Complete</td>
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<tr>
<td>PB 5</td>
<td>Income Recognition on Loans to Financially Troubled Countries</td>
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<tr>
<td>PB 6</td>
<td>Amortization of Discounts on Certain Acquired Loans</td>
<td>Superseded by SOP 03-3</td>
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## STATUTORY ACCOUNTING PRINCIPLES
### GAAP CROSS-REFERENCE TO STATUTORY ACCOUNTING PRINCIPLES

#### PRE-CODIFICATION STANDARDS - CATEGORY C GAAP

**AICPA PRACTICE BULLETINS**

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<td>Compensation Involved in Stock Option and Stock Purchase Plans: Unofficial Accounting Interpretations of Accounting Research Bulletin No. 43, Chapter 13B</td>
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### Appendix D

**GAAP Cross-Reference to SAP**

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<td>AIN-APB26</td>
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<td>AIN-APB30</td>
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Note: SSAP No. 24 adopts guidance related 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 interpretations related to the accounting and reporting of discontinued operations, extraordinary items, and unusual or infrequently occurring events and transactions.
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¹ Information provided within this Appendix D supplement has been obtained from the FASB Cross-Reference Tool. This supplement serves as a reference tool in tracing the FASB Codification to pre-codification GAAP standards that have been reviewed, or are pending review as part of the current NAIC statutory accounting maintenance process. This supplement does not indicate which GAAP standards have been adopted, adopted with modification or rejected for statutory accounting. Pre-codification GAAP guidance not captured as part of the statutory accounting maintenance process, but that has been incorporated in the FASB Codification, has not been referenced within this Supplement. Future consideration will occur on whether this pre-codification GAAP guidance will be reviewed for statutory accounting. Pre-codification GAAP included in the FASB codification, but not referenced within this supplement includes: FASB Derivative Implementation Group Issues; EITF Appendix D Topics; FASB Statement No. 138 Examples; FASB Staff Implementation Guides; AICPA Technical Inquiry Service and Audit and Accounting Guides. (The Audit and Accounting Guides (AAG) related to insurance have been reviewed for statutory accounting and are referenced in this supplement – HCO: Health Care Organizations, LHI: Life and Health Insurance and PLI: Property and Liability Insurance Companies. This supplement also does not include reference to the SEC standards incorporated within the FASB Codification: SEC Financial Reporting Releases; SEC Interpretive Releases; SEC Staff Accounting Bulletins; and SEC Regulation S-X.

*** Indicates that the guidance that comprises this FASB Codification section was not previously part of the statutory maintenance process (i.e., below category “c” of the pre-codification GAAP hierarchy or SEC) or that no reference to previous GAAP guidance was reflected in the FASB Cross-Reference Tool.
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### 250 – Accounting Changes and Error Corrections

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### GAAP Cross-Reference to SAP

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| 825-20                            | Registration Payment Arrangements | FSP EITF 00-19-2 |

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¹For 2011-2012: Only FASB Codification Sections with one or two levels of hierarchy are included.
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Appendix E
Statutory Issue Papers

Introduction

Appendix E includes all of the issue papers associated with SSAPs adopted through December 2010. The issue papers are used as the first step in developing new or substantively revised 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 Manual of the NAIC Securities Valuation Office* (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 Manual of the NAIC Securities Valuation Office - 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 Manual of the NAIC Securities Valuation Office (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
Definition of Cash

- Accounting Practices and Procedures (EX4) Task Force Minutes
- Purposes and Procedures Manual of the NAIC Securities Valuation Office, Section 2
- NAIC Annual Statement Instructions

**Generally Accepted Accounting Principles**
- FASB Statement No. 95, Statement of Cash Flows

**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.
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\(^1\) 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:

- Specifically identified within the Codification as a nonadmitted asset or
- 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\(^1\) 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\(^1\) 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.

\(^1\) 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...

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

13. The Conclusion above adopts certain principles in *FASB Statement No. 5, Accounting for Contingencies* (FAS 5), *FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan* (FAS 114) – only as it amends in part FAS 5, and paragraphs 35 and 36 of *FASB Statement of Concepts No. 6—Elements of Financial Statements*. *FASB Interpretation No. 14, Reasonable Estimation of Amounts of a Loss, An Interpretation of FASB Statement No. 5* is adopted with the modification to accrue the loss amount as the midpoint of the range rather than the minimum. This issue paper also adopts *FASB Interpretation No. 34, Disclosure of Indirect Guarantees of Indebtedness of Others, An interpretation of FASB Statement No. 5*, and *Accounting Principles Board Opinion No. 12, Omnibus Opinion—1967*, paragraphs 2 and 3.

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\(^{21}\) future sacrifices of economic benefits arising from obligations\(^{22}\) of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

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\(^{21}\) 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).

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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 enterprises. 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.

b) The amount of loss can be reasonably estimated.
Disclosure of Loss Contingencies

9. Disclosure of the nature of an accrual 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. 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.

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.

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. 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.

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 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.

³The 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 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.

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.

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. 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.

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.

Installments
   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 NAIC Securities Valuation Office).

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.”
Chapter 16, 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 movements 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.”

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.”

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 NAIC Securities Valuation Office*. 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**


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 insurer's 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.
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
- 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 make up 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

   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 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 agents 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.
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.

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.

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.

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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

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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.
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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 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 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
Uncollected Premium Balances

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.)

9. The Accounting Practices and Procedures Manual for Property and Casualty Insurance 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 incurrence of a liability.

³ 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. 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.

3Paragraphs 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.

4Date 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
Uncollected Premium Balances

- **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,

   1 In this issue paper, vested rights are those for which the reporting entity 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 issue paper, 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.

   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\(^2\),

\(^1\) 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.

   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.

\(^3\) 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 Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets. Outstanding checks are accounted for as a reduction of cash.
Drafting Notes/Comments
None

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 the 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
- 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 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 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

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
(2) The amount of any unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)

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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 benefits 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.
(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.
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
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

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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 (hereinafter “process”) or in bringing about a significant improvement to an existing product or process.

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
- Idaho Statutes, Insurance Laws, Title 41, Insurance, Chapter 6, Assets and Liabilities
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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.

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.

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.

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 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-lessees note, if any, increase the seller-lessees deposit account. The property and related debt continue to be in the seller-lessees 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 lessor'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 lease, 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 insurers 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 form 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. [FAS13, ¶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 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 value 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. 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]

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4a 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]

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.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. 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]

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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]

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.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,\(^{13a}\) 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]

\(^{13a}\) Refer to paragraphs .525 through .527F for supplemental guidance on accounting for operating leases with scheduled rent increases and lease incentives.

.112 The following information with respect to leases shall be disclosed in the lessee's 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 lessee's 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

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 gross investment in the lease.\(^{13b}\) [FAS13, ¶17] 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.\(^{14}\) [FAS23, ¶9] 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. [FAS98, ¶22g]

\(^{13b}\) 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]

b. 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.\(^{15}\) 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 accruable. [FAS29, ¶13] [(Refer to paragraph .165 for an illustration involving contingent rentals.)]

\(^{15}\) This is the interest method described in Section 169, paragraph .108 and footnote 4. [FAS13, ¶12, fn 11]

c. 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.\(^{16}\) 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.
Paragraphs .514 through .517 discuss upward adjustment of guaranteed residential values.

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]

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]

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\(^{18}\) 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]

(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]

\(^{19}\) 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 D14, “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]
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,\textsuperscript{24a} 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.

\textsuperscript{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 involving real estate 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

.128 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 equipment\textsuperscript{27a} 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).]

\textsuperscript{27a} The terms \textit{property improvements} and \textit{integral equipment} are discussed in paragraph .130A and footnote 32a.
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 sale shall be deferred and amortized in proportion to the amortization of the lease asset, 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), 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.

b. The seller-lessee retains more than a minor part but less than substantially all of the use of the property through the leaseback and realizes a profit on the sale in excess of the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease, or 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-lessee] shall record the transaction as a purchase and a direct financing lease; otherwise, the [buyer-lessee] shall record the transaction as a purchase and an operating lease. [FAS 13, paragraph 34]

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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-lessee] 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]

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-lessee 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. \([FAS98, \S 6, fn2]\)

\(^{32b}\) 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. \([FAS98, \S 6, fn3]\)

Sale-Leaseback Accounting

.130B 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. \([FAS98, \text{paragraph 70}]\)

Criteria for Sale-Leaseback Accounting

.130C 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-lessee'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. \([FAS98, \text{paragraph 7}]\)

.130D A *normal leaseback* is 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,\(^{32c}\) 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.\(^{32d}\) 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-lessee. The latter type of contingent rental is addressed in paragraph .130H(e) of this section. [FAS98, ¶8, fn4]

32d The term "minor" is used here in the context of the definition in footnote 30 to paragraph .129. [FAS98, ¶8, 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-lessee. 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-lessee. 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 option32e 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. [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-lessee 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-lessee 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-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.

e. The seller-lessee's rental payment is contingent on some predetermined or determinable level of future operations of the buyer-lessee. [FAS98, ¶12]

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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]

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.130I 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 without leasing the underlying land to the buyer-lessee. [FAS98, ¶13]

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, ¶14]

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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]

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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]
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

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]

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 unremitting 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]

36a Paragraphs .536 and .537 further discuss residual value retained by a lessor that sells rental payments.

37 It is recognized that the investment tax credit may be accounted for other than as prescribed here, as provided by Congress in the Revenue Act of 1971. [FAS13, ¶42, fn24]

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 [FAS23, ¶10]

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

38 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]

.146 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]

39 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]

.147 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]

40 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]

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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.

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Accounting for Income Taxes

Section I27, “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 I27 is required when deferred tax credits related to leveraged leases are the only source (refer to paragraph .120 of Section I27) 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 I27, 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]

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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 I27 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]

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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 I27 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 I27 presents an example that integrates the] accounting for leveraged leases [as required by this section] and the accounting for income taxes required by Section I27. [FAS109, ¶258]

Disclosures

.149 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]

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401 Fair Rental in this context shall mean the expected rental for equivalent property under similar terms and conditions. [FAS13, ¶5, fn 2]

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.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
Leases

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 enters into a new lease with the same lessor, or (4) 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]
Lessee's 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.\textsuperscript{406}

\textsuperscript{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.\textsuperscript{407} 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\textsuperscript{408} 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,\textsuperscript{409} rather than an estimate of the deficiency to be made up.

\textsuperscript{407} A guarantee of the residual value obtained by the lessee from an unrelated third party for the benefit of the lessor shall not be used to reduce the amount of the lessees minimum lease payments except to the extent that the lessor explicitly releases the lessee from obligation, including secondary obligation if the guarantor defaults, to make up a residual value deficiency. Amounts paid in consideration for a guarantee by an unrelated third party are executory costs and are not included in the lessees minimum lease payments.

\textsuperscript{408} A lease provision requiring the lessee to make up a residual value deficiency that is attributable to damage, extraordinary wear and tear, or excessive usage is similar to contingent rentals in that the amount is not determinable at the inception of the lease. Such a provision does not constitute a lessee guarantee of the residual value.

\textsuperscript{409} If a lease limits the amount of the lessees obligation to make up a residual value deficiency to an amount less than the stipulated residual value of the leased property at the end of the lease term, the amount of the lessees guarantee to be included in minimum lease payments shall be limited to the specified maximum deficiency the lessee can be required to make up. If that maximum deficiency clearly exceeds any reasonable estimate of a deficiency that might be expected to arise in normal circumstances, the lessors risk associated with the portion of the residual in excess of the maximum may appear to be negligible. However, the fact remains that the lessor must look to the resale market or elsewhere rather than to the lessee to recover the unguaranteed portion of the stipulated residual value of the leased property. The lessee has not guaranteed full recovery of the residual value, and the parties should not base their accounting on the assumption that the lessee has guaranteed it.
(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
Sublease revenue
550

To record cash received from sublease of the property

Recurring journal entries in years 1-8:

Cash
Rental revenue
Incentive to lessee (1,000/8 years)
1,200
1,075
125

To record cash received on new lease and amortization of incentive over new lease term

Lessee Accounting

At inception:

Loss on sublease assumed by lessor
Incentive from lessor
960
960

To record loss on sublease assumed in conjunction with new lease agreement

Recurring journal entries in years 1-8:

Lease expense
Incentive from lessor (960/8 years)
Cash
1,080
120
1,200

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]
  - 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.
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. 

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.

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.

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.

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.

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.

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.
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:

\[
\text{Income from continuing operations before income taxes}^2 \quad \text{XXXX} \\
\text{Provision for income taxes} \quad \text{XXX} \\
\hline
\text{Income from continuing operations}^2 \quad \text{XXXXXX} \\
\text{Discontinued operations(Note______):} \\
\text{Income (loss) from operations of discontinued Division X} \\
\text{(less applicable income taxes of$_____)} \quad \text{XXXXXX} \\
\text{Loss on disposal of Division X, including provision of$_____ for operating losses during phase-out period (less applicable income taxes of$______)} \quad \text{XXXX} \\
\hline
\text{Net Income} \quad \text{XXXXX} \\
\text{====}
\]

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.
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

\(^4\) 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.\(^6\)

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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 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,\(^7\) 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 Purposes and Procedures Manual of the NAIC 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 ½ 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 NAIC Securities Valuation Office*.

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.
- 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.

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<tr>
<td>b. Depreciated</td>
<td>LCM (1)</td>
<td>Market</td>
</tr>
<tr>
<td>2. Transfer of Preferred Stock</td>
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</tr>
<tr>
<td>a. Sinking Fund</td>
<td>Cost (1)</td>
<td>Market</td>
</tr>
<tr>
<td>b. Perpetual Preferred Held by Life Co.</td>
<td>Cost (1)</td>
<td>Market</td>
</tr>
<tr>
<td>c. All others</td>
<td>Market</td>
<td>Market</td>
</tr>
<tr>
<td>3. Transfer of Common Stock</td>
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<td></td>
<td>Market</td>
<td>Market</td>
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<tr>
<td>4. Transfer of Real Estate</td>
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<tr>
<td></td>
<td>Cost</td>
<td>Market</td>
</tr>
<tr>
<td>5. Transfer of Loans or Loan Participations</td>
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</tr>
<tr>
<td>a. Appreciated</td>
<td>Cost</td>
<td>Market</td>
</tr>
<tr>
<td>b. Depreciated</td>
<td>LCM</td>
<td>Market</td>
</tr>
<tr>
<td>6. Intercompany Loans</td>
<td>LCM (2)</td>
<td>Market (2)</td>
</tr>
<tr>
<td>7. Sale/Leaseback</td>
<td>Cost/LCM (3)</td>
<td>Market</td>
</tr>
<tr>
<td>8. Reverse Repurchase Agreements</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:
(2) 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.

a. The nature of the relationship(s) involved
b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
c. The dollar amounts of transactions for each of the periods for which income 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

3. Transactions involving related parties cannot be presumed to be carried out on an arm's length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's length transactions unless such representations can be substantiated.

4. If the reporting enterprise and one or more other enterprises are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting enterprise significantly different from those that would have been obtained if the enterprises were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the enterprises.

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.
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 follow:

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 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.

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 Manual of the NAIC Securities Valuation Office* 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,
collateral coverage, cash flow coverage of debt service and other strengths inherent in the structural factors unique to the DIP lending process.

(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 and
(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></td>
</tr>
<tr>
<td>1</td>
<td>Amortized Cost</td>
<td>RATE AMOUNT</td>
</tr>
<tr>
<td>2</td>
<td>Amortized Cost</td>
<td>Market Value</td>
</tr>
<tr>
<td></td>
<td>Par Value X Rate</td>
<td>or Amortized Cost</td>
</tr>
<tr>
<td>3</td>
<td>Amortized Cost</td>
<td>if shown</td>
</tr>
<tr>
<td></td>
<td>Amortized Cost</td>
<td>or if No Rate</td>
</tr>
<tr>
<td>4</td>
<td>Amortized Cost</td>
<td>A.V.</td>
</tr>
<tr>
<td>5</td>
<td>Amortized Cost</td>
<td>Available</td>
</tr>
<tr>
<td>6</td>
<td>The lesser of the Market Value Amount or Amortized Cost</td>
<td>Lower of VOS Available or Amortized Cost</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>
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</tr>
<tr>
<td>1</td>
<td>Amortized Cost</td>
<td>RATE MARKET VALUE</td>
</tr>
<tr>
<td>2</td>
<td>Amortized Cost</td>
<td>if shown</td>
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<tr>
<td></td>
<td>Lower of Amortized</td>
<td></td>
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<tr>
<td></td>
<td>or Lower of Amortized Rate</td>
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<tr>
<td></td>
<td>A.V. Cost or Par Value</td>
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<tr>
<td></td>
<td>if shown X Rate</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized</td>
</tr>
<tr>
<td></td>
<td>No Rate</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cost or Par Value</td>
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<tr>
<td></td>
<td>shown X Rate</td>
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<tr>
<td>5</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized</td>
</tr>
<tr>
<td></td>
<td>In VOS</td>
<td></td>
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<tr>
<td></td>
<td>Cost or Par Value</td>
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<tr>
<td></td>
<td>Manual 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</td>
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<td></td>
<td>Lower of Amortized</td>
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<tr>
<td></td>
<td>Cost or Par Value</td>
<td></td>
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<tr>
<td></td>
<td>X Rate</td>
<td></td>
</tr>
</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:
Bonds, Excluding Loan-Backed and Structured Securities

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. 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.

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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 yield (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.

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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.

   ________________

3 The term remote is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

   ________________

   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
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.  

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.

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.

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.\(^4\)
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 Loaned 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 Manual of the NAIC Securities Valuation Office

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.
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 to (1) 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 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
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.

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 NAIC Securities Valuation Office.

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 Manual of the NAIC Securities Valuation Office (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
- Purposes and Procedures Manual of the NAIC Securities Valuation Office, 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 Manual of the NAIC Securities Valuation Office, 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 Manual of the NAIC Securities Valuation Office. 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 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 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.

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 Extinguishments 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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - 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

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(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.
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)  

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.

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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,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.

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" 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.

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 pledge) 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 “Collateral”</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.

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 Manual of the NAIC Securities Valuation Office, 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
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 Manual of the NAIC Securities Valuation Office (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.

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 any loaned 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 Extinguishments 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.

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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - 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); and
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 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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<td>PSF-1 Thru</td>
<td>Cost or Amortized Cost</td>
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<td>PSF-3</td>
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<td>Market Rate</td>
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<td>PSF-4 Thru</td>
<td>Lower of Cost, Amortized Cost or Market Value</td>
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<td>PSF6</td>
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<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>
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<td>Market Rate</td>
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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

(2) For Insurers Not Maintaining an Asset Valuation Reserve (AVR)

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<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>STATEMENT VALUE COLUMN</th>
<th>MARKET VALUE COLUMNS</th>
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<td>PSF-2</td>
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<td>PSF-3 Thru</td>
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<td>P-1 Thru P-2</td>
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<td>Market Rate</td>
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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 º 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.\textsuperscript{4} 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.

\textsuperscript{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.

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\(^3\) 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 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.

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.

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.

\[^{11}\]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 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 Manual of the NAIC Securities Valuation Office, 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—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.
** For purposes of this Statement, derivative financial instrument is used in the same sense as in paragraph 5 of FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.

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.
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.
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 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 estimate 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 incurred 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 insurers 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 deferment, 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 deferment, 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.

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, expect 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 reasonably 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
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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 Manual of the NAIC Securities Valuation Office* (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
Troubled Debt Restructurings

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 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.

14. The conclusions above are consistent with the accounting for impaired mortgage loans in Issue Paper No. 37—Mortgage Loans (Issue Paper No. 37) which adopts FAS 114 for accounting for collateral dependent loans.

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. 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.  

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.

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.

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. 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.

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. 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.\textsuperscript{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.\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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).\textsuperscript{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.\textsuperscript{12}

\textsuperscript{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.

\textsuperscript{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.13 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.14 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.

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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.

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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, the 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: 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).\(^{16}\) The excess of (i) the recorded investment in the receivable\(^{17}\) 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.\(^{22}\) 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.\(^{23}\)

\(^{22}\) 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 unit26 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 control27 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.

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26 Government units include, but are not limited to, states, counties, townships, municipalities, school districts, authorities, and commissions.

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.

\[\text{2 The term recorded investment in the loan is distinguished from net carrying amount of the loan because the latter term is net of a valuation allowance, while the former term is not. The recorded investment in the loan does, however, reflect any direct write-down of the investment.}\]

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.

\[\text{3 A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the}\]
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

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-
Troubled Debt Restructurings

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 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.]
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. 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 from the original loan 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, any additional amounts loaned, any fees received, and direct loan origination costs set forth in paragraph 6 associated with the refinancing or restructuring.
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.

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
- 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) Loan

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

Derivative Financial Instruments (as it relates to disclosure about financial instruments with off-balance-sheet risk),
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 acquirer 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 incurred 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 yield (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.
3 The term remote is used here, consistent with its use in FASB Statement No. 5, Accounting for Contingencies, to mean that the likelihood is slight that a loan commitment will be exercised prior to its expiration.

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.6 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.⁷ (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).

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 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).\(^3\) 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 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).

\(^N2\)
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, N3 and the AICPA audit and accounting guide entitled, Savings and Loan Associations, N4 provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

2. In the case of a real estate joint venture, the provisions of SOP no. 78-9, Accounting for Investments in Real Estate Ventures, N5 and SFAS no. 34, Capitalization of Interest Cost, N6 as amended by SFAS no. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method, 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.

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 uncollected 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 1, 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
- Texas Insurance Code, Chapter 3, Life, Health and Accident Insurance, Subchapter C, Reserves and Investments, Art. 3.33
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 borrower’s 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.
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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 (FAS 60), FASB Statement No. 66, Accounting for Sales of Real Estate (FAS 66), FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects (FAS 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—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 knowledgeably 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.

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”

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 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 real estate ventures are addressed in Issue Paper No. 48—Investments in Joint Ventures, Partnerships and Limited Liability Companies.
- Accounting for leases 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.

25. 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 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.

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:

\(^1\) 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.

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.

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\(^4\)

\(^4\) 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,\(^6\) on the excess of the aggregate actual debt on the property over such a maximum first mortgage loan

\(^6\) 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 Rights 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\(^7\) 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.

\(^7\) 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\(^8\) part of the sales price. The transaction shall be accounted for as a financing, leasing, or profit-sharing arrangement.

\(^8\) 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)

28. The seller guarantees\(^9\) 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.

\(^9\) Guarantees by the seller may be limited to a specified period of time.

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\(^10\) 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.

\(^10\) 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\textsuperscript{12} 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:

\begin{itemize}
\item \textbf{a.} Construction is beyond a preliminary stage.\textsuperscript{13}
\item \textbf{b.} The buyer is committed to the extent of being unable to require a refund except for nondelivery of the unit or interest.\textsuperscript{14}
\item \textbf{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.
\item \textbf{d.} Sales prices are collectible (paragraph 4).
\item \textbf{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.
\end{itemize}

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.

\textsuperscript{12} A condominium project may be a building, a group of buildings, or a complete project.

\textsuperscript{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.

\textsuperscript{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.
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\textsuperscript{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.

\textsuperscript{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 \textit{FASB Statement No. 13, Accounting for Leases}, and \textit{FASB Statement No. 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.\(^{16}\) 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.

\(^{16}\) 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\(^{17}\) that have been consummated.\(^{18}\) That method of recognizing profit shall be changed when certain conditions are met for the entire project (paragraph 49).

\(^{17}\) 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.

\(^{18}\) 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.\(^{19}\) The collection experience with the seller's prior projects may be applied to a new project if the prior projects:

\(^{19}\) 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)\(^{20}\) as the new project.

\(^{20}\) 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

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.

| Land | Held for commercial, industrial, or residential development to commence within two years after sale | 20 |
|      | Held for commercial, industrial, or residential development to commence after two years | 25 |

| Commercial and Industrial Property | Office and industrial buildings, shopping centers, and so forth: |
|                                  | Properties subject to lease on a long-term lease basis to parties with satisfactory credit rating; cash flow currently sufficient to service all indebtedness | 10 |
|                                  | Single-tenancy properties sold to a buyer with a satisfactory credit rating | 15 |
|                                  | All other | 20 |

| Other income-producing properties (hotels, motels, marinas, mobile home parks, and so forth): |
| Cash flow currently sufficient to service all indebtedness | 15 |
| Start-up situations or current deficiencies in cash flow | 25 |

| Multifamily Residential Property | Primary residence: |
| Cash flow currently sufficient to service all indebtedness | 10 |
| Start-up situations or current deficiencies in cash flow | 15 |
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: 5a
- Secondary or recreational residence: 10a

---

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.
Real Estate Investments

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.

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 (Terms--15 percent interest payable annually over 20 years: $79,881 per year including principal and interest)</td>
<td>$500,000</td>
</tr>
<tr>
<td>Second mortgage note payable to seller (Terms--12 percent interest payable annually over 25 years: $31,875 per year including principal and interest)</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.

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

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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 26 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 27 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

Computation:

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 760,000
Total debt or equivalent 854,000
Down payment 154,000
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 0.96432696) $157,000
- Loan from insurance company (primary debt) 743,000

$1,032,000

The initial investment ($132,000) is less than 15% of the sales value ($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

The percentage of profit in each collection is therefore:
- $82,000
- $289,000 = 28.37%

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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

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</th>
<th>Total Estimated 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></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

Safety factor of 1/3 of rental revenue

Adjusted anticipated net deficit in cash flow

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>
</tr>
</thead>
<tbody>
<tr>
<td>Sales value</td>
</tr>
<tr>
<td>Adjusted--projected rental revenue</td>
</tr>
<tr>
<td>19X2</td>
</tr>
<tr>
<td>19X3</td>
</tr>
<tr>
<td>19X4</td>
</tr>
<tr>
<td><strong>1,370,000</strong></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>
</tr>
</thead>
<tbody>
<tr>
<td>Total estimated costs of project (paragraph 85(e))</td>
</tr>
<tr>
<td>Estimated rental expenses and debt service</td>
</tr>
<tr>
<td>19X2</td>
</tr>
<tr>
<td>19X3</td>
</tr>
<tr>
<td>19X4</td>
</tr>
<tr>
<td><strong>1,270,000</strong></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
88. Schedule B

Example of Profit Calculation
(assuming actual rental revenue equals unadjusted projection)
(in thousands)

<table>
<thead>
<tr>
<th></th>
<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>
<td>19X4</td>
</tr>
<tr>
<td><strong>REVENUES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales value</td>
<td>$1,100</td>
<td>$1,100</td>
<td>$1,100</td>
</tr>
<tr>
<td>Adjusted--projected</td>
<td>$1,270</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rental revenue)*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>19X2</td>
<td>50</td>
<td>50</td>
<td>75†</td>
</tr>
<tr>
<td>19X3</td>
<td>100</td>
<td>100</td>
<td>150†</td>
</tr>
<tr>
<td>19X4</td>
<td>120</td>
<td>120</td>
<td>150§‡</td>
</tr>
<tr>
<td></td>
<td>1,370</td>
<td>1,370</td>
<td>1,395</td>
</tr>
<tr>
<td></td>
<td>1,370</td>
<td></td>
<td>1,475</td>
</tr>
<tr>
<td></td>
<td>1,476</td>
<td></td>
<td>1,476</td>
</tr>
<tr>
<td><strong>COSTS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Same as Schedule A</td>
<td>1,270</td>
<td>1,270</td>
<td>1,270</td>
</tr>
<tr>
<td>TOTAL PROJECTED PROFIT</td>
<td>$100</td>
<td>$100</td>
<td>$125</td>
</tr>
<tr>
<td></td>
<td>$205</td>
<td></td>
<td>$206</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

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

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
Profit recognized during support period (19X3):

\[
\begin{align*}
$1,119,000 \\
1,270,000 \times 205,000 &= $180,626 \\
\end{align*}
\]

Total profit to date $180,626
Less profit previously reported 95,276
Current profit recognition $ 85,350

Profit recognized during support period (19X4):

\[
\begin{align*}
$1,270,000 \\
1,270,000 \times 206,000 &= $206,000 \\
\end{align*}
\]

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

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 (Net sales $820, less discount $150)  570

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</th>
<th>Interest*</th>
<th>Annual Collections</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>$ 62</td>
<td>$ 42</td>
<td>$104</td>
<td>$ 97</td>
</tr>
<tr>
<td>3</td>
<td>66</td>
<td>38</td>
<td>104</td>
<td>87</td>
</tr>
<tr>
<td>4</td>
<td>70</td>
<td>34</td>
<td>104</td>
<td>77</td>
</tr>
<tr>
<td>5</td>
<td>75</td>
<td>29</td>
<td>104</td>
<td>68</td>
</tr>
<tr>
<td>6</td>
<td>79</td>
<td>25</td>
<td>104</td>
<td>60</td>
</tr>
<tr>
<td>7</td>
<td>84</td>
<td>20</td>
<td>104</td>
<td>53</td>
</tr>
<tr>
<td>8</td>
<td>89</td>
<td>15</td>
<td>104</td>
<td>47</td>
</tr>
<tr>
<td>9</td>
<td>95</td>
<td>9</td>
<td>104</td>
<td>43</td>
</tr>
<tr>
<td>10</td>
<td>100</td>
<td>4</td>
<td>104</td>
<td>38</td>
</tr>
</tbody>
</table>

$720 $216 $936 $570

*Assumes no interest for year 1.

93. Schedule B

Computation of Interest Income for Financial Reporting Purposes

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash</th>
<th>Discount</th>
<th>Valuation</th>
<th>Debit:</th>
<th>Credit:</th>
<th>Credit:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Unamortized</td>
<td>Contracts</td>
<td>Interest</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Receivable</td>
<td>Income*</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$104</td>
<td>$ 24</td>
<td>(62)</td>
<td>(66)</td>
<td>(62)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>104</td>
<td>24</td>
<td>(66)</td>
<td>(70)</td>
<td>(56)</td>
<td>(50)</td>
</tr>
<tr>
<td>4</td>
<td>104</td>
<td>22</td>
<td>(70)</td>
<td>(75)</td>
<td>(50)</td>
<td>(44)</td>
</tr>
<tr>
<td>5</td>
<td>104</td>
<td>21</td>
<td>(75)</td>
<td>(84)</td>
<td>(36)</td>
<td>(27)</td>
</tr>
<tr>
<td>6</td>
<td>104</td>
<td>19</td>
<td>(84)</td>
<td>(95)</td>
<td>(17)</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>104</td>
<td>16</td>
<td>(95)</td>
<td>(100)</td>
<td>(8)</td>
<td>(8)</td>
</tr>
<tr>
<td>8</td>
<td>104</td>
<td>12</td>
<td>(100)</td>
<td>(89)</td>
<td>(27)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>104</td>
<td>8</td>
<td>(89)</td>
<td>(95)</td>
<td>(17)</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>104</td>
<td>4</td>
<td>(95)</td>
<td>(100)</td>
<td>(8)</td>
<td>(8)</td>
</tr>
</tbody>
</table>

$936 $150 $(720) $(366)

*Total interest income equals $216 stated interest plus $150 discount, or $366.

94. Schedule C

Determination of Income Tax Payable

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal Receipts</th>
<th>Profit from Sale</th>
<th>Interest Income from Receivable</th>
<th>Selling Expense $(300)</th>
<th>Taxable Income $(218)</th>
<th>Tax from Year 1</th>
<th>Tax carry-forward</th>
<th>Net 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>
<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>
<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>
<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>
<td></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>
<td></td>
</tr>
<tr>
<td>6</td>
<td>79</td>
<td>61</td>
<td>25</td>
<td>86</td>
<td>(41)</td>
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<tr>
<td>7</td>
<td>84</td>
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<td>85</td>
<td>(41)</td>
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<td>8</td>
<td>89</td>
<td>69</td>
<td>15</td>
<td>84</td>
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<td>9</td>
<td>95</td>
<td>74</td>
<td>9</td>
<td>83</td>
<td>(40)</td>
<td>(40)</td>
<td></td>
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</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>
<td></td>
</tr>
</tbody>
</table>

$820 $640 $216 $(300) $556 $(372) $105† $(267)
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>Balance Sheets</th>
<th>Beginning of Year 1</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>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$300</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>
<td>$615</td>
<td>$649</td>
</tr>
<tr>
<td>Contracts receivable</td>
<td>720</td>
<td>658</td>
<td>592</td>
<td>522</td>
<td>447</td>
<td>368</td>
<td>284</td>
<td>195</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Allowance for contract cancellations*</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>Unamortized valuation discount</td>
<td>(150)</td>
<td>(126)</td>
<td>(102)</td>
<td>(80)</td>
<td>(60)</td>
<td>(40)</td>
<td>(24)</td>
<td>(12)</td>
<td>(4)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>75</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td><strong>Liabilities and equity:</strong></td>
<td>$375</td>
<td>$685</td>
<td>$751</td>
<td>$813</td>
<td>$846</td>
<td>$854</td>
<td>$857</td>
<td>$822</td>
<td>$779</td>
<td>$726</td>
<td>$664</td>
</tr>
<tr>
<td>Deferred income taxes</td>
<td>$ 71</td>
<td>$103</td>
<td>$133</td>
<td>$137</td>
<td>$119</td>
<td>$100</td>
<td>$81</td>
<td>$59</td>
<td>$32</td>
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<td></td>
</tr>
<tr>
<td>Revenue applicable to future improvements†</td>
<td>163</td>
<td>163</td>
<td>163</td>
<td>163</td>
<td>163</td>
<td>122</td>
<td>81</td>
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<td></td>
</tr>
<tr>
<td>Capital stock</td>
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<td>375</td>
<td>375</td>
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<td>375</td>
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<tr>
<td>Retained earnings</td>
<td>76</td>
<td>110</td>
<td>142</td>
<td>171</td>
<td>197</td>
<td>219</td>
<td>244</td>
<td>264</td>
<td>279</td>
<td>289</td>
<td></td>
</tr>
<tr>
<td><strong>Income Statements</strong></td>
<td>$375</td>
<td>$685</td>
<td>$751</td>
<td>$813</td>
<td>$846</td>
<td>$854</td>
<td>$857</td>
<td>$822</td>
<td>$779</td>
<td>$726</td>
<td>$664</td>
</tr>
</tbody>
</table>

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IP 40–46
### Improvement revenue--prior sales

<table>
<thead>
<tr>
<th></th>
<th>$41</th>
<th>$41</th>
<th>$41</th>
<th>$40</th>
<th>163</th>
</tr>
</thead>
</table>

### Interest income (Schedule B)

<table>
<thead>
<tr>
<th></th>
<th>$66</th>
<th>$62</th>
<th>$56</th>
<th>$50</th>
<th>$44</th>
<th>36</th>
<th>27</th>
<th>17</th>
<th>8</th>
<th>366</th>
</tr>
</thead>
</table>

Costs and expenses:

<table>
<thead>
<tr>
<th>Cost of sales</th>
<th>60</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Improvement costs--prior sales</th>
<th>30</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Selling expenses</th>
<th>300</th>
</tr>
</thead>
</table>

| Income before provision for income taxes | 147 |

Provision for income taxes:

<table>
<thead>
<tr>
<th>Current</th>
<th>71</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Deferred</th>
<th>32</th>
</tr>
</thead>
</table>

| Net Income | $76 |

---

* 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>Beginning</th>
<th>Of Year 1</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>Assets:</td>
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<td></td>
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</tr>
<tr>
<td>Cash</td>
<td>$300</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>
<td>$615</td>
<td>$649</td>
</tr>
<tr>
<td>Contracts receivable</td>
<td>720</td>
<td>658</td>
<td>592</td>
<td>522</td>
<td>447</td>
<td>368</td>
<td>284</td>
<td>195</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Profit applicable future improvements</td>
<td>(342)</td>
<td>(313)</td>
<td>(282)</td>
<td>(249)</td>
<td>(213)</td>
<td>(175)</td>
<td>(135)</td>
<td>(93)</td>
<td>(48)</td>
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<tr>
<td>Land</td>
<td>75</td>
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<td>15</td>
<td>15</td>
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<tr>
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<td>$564</td>
<td>$633</td>
<td>$677</td>
<td>$700</td>
<td>$722</td>
<td>$711</td>
<td>$698</td>
<td>$682</td>
<td>$664</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 | $90 | $60 | $30 |
| Capital stock | $375 | 375 | 375 | 375 | 375 | 375 | 375 | 375 | 375 |
| Retained earnings (deficit) | $493 | $564 | $633 | $677 | $700 | $722 | $711 | $698 | $682 | $664 |

---

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### Income Statements

<table>
<thead>
<tr>
<th>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>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</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>$1,000</td>
<td></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>216</td>
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<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>(427)</td>
<td></td>
</tr>
<tr>
<td>Profit recognized†</td>
<td>29</td>
<td>31</td>
<td>33</td>
<td>36</td>
<td>38</td>
<td>40</td>
<td>42</td>
<td>45</td>
<td>48</td>
<td>342</td>
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</tr>
<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>
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<td>54</td>
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<td>Costs and expenses:</td>
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<td></td>
<td></td>
<td></td>
<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>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>225</td>
<td></td>
</tr>
<tr>
<td>Selling expenses</td>
<td>300</td>
<td>300</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>300</td>
<td></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>50</td>
<td></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>
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</tr>
<tr>
<td>Current</td>
<td>23</td>
<td>23</td>
<td>33</td>
<td>33</td>
<td>9</td>
<td>(11)</td>
<td>(10)</td>
<td>(12)</td>
<td>(13)</td>
<td>(14)</td>
<td>(15)</td>
</tr>
<tr>
<td>Deferred</td>
<td>23</td>
<td>33</td>
<td>33</td>
<td>32</td>
<td>31</td>
<td>29</td>
<td>27</td>
<td>26</td>
<td>25</td>
<td></td>
<td></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

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97. Schedule B

Installment Method Changed to Percentage-of-Completion Method at Beginning of Year 4
(amounts in thousands)

<table>
<thead>
<tr>
<th>Balance Sheets</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>Assets:</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>
<td>$615</td>
<td>$649</td>
</tr>
<tr>
<td>Contracts receivable</td>
<td>720</td>
<td>658</td>
<td>592</td>
<td>522</td>
<td>447</td>
<td>368</td>
<td>284</td>
<td>195</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit applicable to future improvements</td>
<td>(342)</td>
<td>(313)</td>
<td>(282)</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unamortized valuation discount</td>
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<td>(59)</td>
<td>(40)</td>
<td>(24)</td>
<td>(12)</td>
<td>(4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<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>
<td></td>
</tr>
</tbody>
</table>

| Liabilities and equity: |   |   |   |   |   |   |   |   |   |    |
| Deferred income taxes | $ 33 | $ 66 | $137 | $119 | $100 | $ 81 | $ 59 | $ 32 |   |    |
| Liability for future improvements (revenue applicable to future improvements after Year 3) | $120 | $120 | $120 | $163 | $163 | $163 | $122 | $81 | 40 |    |
| Capital stock | 375 | 375 | 375 | 375 | 375 | 375 | 375 | 375 | 375 | $375 |
| Retained earnings (deficit) | (2) | 36 | 72 | 171 | 197 | 219 | 244 | 264 | 279 | 289 |
| $493 | $564 | $633 | $846 | $854 | $857 | $822 | $779 | $726 | $664 |

<table>
<thead>
<tr>
<th>Income Statements</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 contracts recorded</td>
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<td></td>
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</tr>
<tr>
<td>Improvement revenue--prior sales</td>
<td>$41</td>
<td>$41</td>
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<td>$40</td>
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<td>163</td>
<td></td>
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<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>60</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>318</td>
<td></td>
</tr>
<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>4573</td>
<td>71</td>
<td>69</td>
<td>193</td>
<td>50</td>
<td>44</td>
<td>77</td>
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<td>58</td>
<td>48</td>
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Costs and expenses:

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<th>Item</th>
<th>Amount (thousands)</th>
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</thead>
<tbody>
<tr>
<td>Cost of sales</td>
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</tr>
<tr>
<td>Improvement costs—prior sales</td>
<td>30 30 30 30 120</td>
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<tr>
<td>Selling expenses</td>
<td>300</td>
</tr>
<tr>
<td>Loss on cancellations</td>
<td>50</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>575</strong></td>
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Income (loss) before provision for income taxes:

<table>
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<th>Year</th>
<th>Amount (thousands)</th>
</tr>
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<tbody>
<tr>
<td>2011</td>
<td>2</td>
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<tr>
<td>2012</td>
<td>61</td>
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<tr>
<td>2013</td>
<td>193</td>
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<td>2014</td>
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<tr>
<td>2015</td>
<td>44</td>
</tr>
<tr>
<td>2016</td>
<td>47</td>
</tr>
<tr>
<td>2017</td>
<td>38</td>
</tr>
<tr>
<td>2018</td>
<td>28</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>556</strong></td>
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Provision for income taxes:

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<th>Amount (thousands)</th>
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<tbody>
<tr>
<td>2011</td>
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<td>2016</td>
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<tr>
<td>2017</td>
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Net income (loss):

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<th>Amount (thousands)</th>
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<td>2019</td>
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</tr>
<tr>
<td>2020</td>
<td>10</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>289</strong></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>Amount (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit not yet recognized under installment method:</td>
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</tr>
<tr>
<td>Original</td>
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</tr>
<tr>
<td>Recognized in prior years</td>
<td>(60)</td>
</tr>
<tr>
<td>Applicable to canceled contracts</td>
<td>(85) $282</td>
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</table>

Less, valuation discount required:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables at beginning of year 4</td>
<td>592</td>
</tr>
<tr>
<td>Present value of payments due (principal and interest)</td>
<td>(490) 102</td>
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</table>

Less:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue to be recognized in future as performance takes place</td>
<td>163 180</td>
</tr>
<tr>
<td>Costs to be recognized in future</td>
<td>(120) 43</td>
</tr>
</tbody>
</table>

Net amount credited to income (before taxes) $137

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 costs² (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 (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.

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. Changes in estimates shall be reported in accordance with paragraph 31 of APB Opinion No. 20, Accounting Changes.

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.

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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 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.

Foreclosed Assets Held for Sale

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.

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.

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."

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 sales 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 complies 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.

(In 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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- *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.*

**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 the Purposes and Procedures Manual of the NAIC Securities Valuation Office (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,
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 and Structured 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. \textit{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, \textit{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), \textit{Issue Paper No. 32—Investments in Preferred Stock} (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities) and \textit{Issue Paper No. 43—Loan-Backed and Structured Securities}.

\textbf{Drafting Notes/Comments}

None

\textbf{RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE}

\textbf{Statutory Accounting}

\textbf{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:

\textbf{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

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
- Purposes and Procedures Manual of the NAIC Securities Valuation Office
- 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 of Financial Accounting Concepts No. 6, Elements of Financial Statements
- 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.
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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.

**Commitment Fees**

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.
- 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...
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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office* - 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)).

(1) For Insurers Maintaining an Asset Valuation Reserve (AVR) (see Section 6)

<table>
<thead>
<tr>
<th>NAIC DESIGNATION COLUMN</th>
<th>AMORTIZED OR INVESTMENT</th>
<th>MARKET VALUE COLUMNS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>VALUE COLUMN</td>
<td>RATE</td>
</tr>
<tr>
<td>1</td>
<td>Amortized Cost</td>
<td>SVO</td>
</tr>
<tr>
<td>2</td>
<td>Amortized Cost</td>
<td>Market Rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Par Value X Rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>or</td>
</tr>
<tr>
<td>3</td>
<td>Amortized Cost</td>
<td>if shown</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Amortized Cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td>or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>if No Rate</td>
</tr>
<tr>
<td>4</td>
<td>Amortized Cost</td>
<td>A.V.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Available</td>
</tr>
<tr>
<td>5</td>
<td>Amortized Cost</td>
<td>if No Rate</td>
</tr>
<tr>
<td>6</td>
<td>The lesser of the</td>
<td>shown in</td>
</tr>
<tr>
<td></td>
<td>Market Value Amount</td>
<td>VOS</td>
</tr>
<tr>
<td></td>
<td>or Amortized Cost</td>
<td>Manual</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Amortized Cost or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Par Value times</td>
</tr>
<tr>
<td></td>
<td></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>1</td>
<td>Amortized Cost</td>
<td>Rate</td>
</tr>
<tr>
<td>2</td>
<td>Amortized Cost</td>
<td>SVO or A.V. if no Market rate available</td>
</tr>
<tr>
<td></td>
<td></td>
<td>if shown</td>
</tr>
<tr>
<td>3</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized A.V. Cost or Par Value</td>
</tr>
<tr>
<td></td>
<td>Or the Amortized Cost</td>
<td>X Rate</td>
</tr>
<tr>
<td>4</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Rate Cost or Par Value</td>
</tr>
<tr>
<td></td>
<td>Rate shown</td>
<td>X Rate</td>
</tr>
<tr>
<td></td>
<td>In VOS</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Manual Cost or Par Value</td>
</tr>
<tr>
<td></td>
<td>Rate</td>
<td>X Rate</td>
</tr>
<tr>
<td>6</td>
<td>The lesser of the Market Value Amount or the Amortized Cost</td>
<td>Lower of Amortized Rate Cost or Par Value</td>
</tr>
<tr>
<td></td>
<td></td>
<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:

- 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.
- 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.
- The mortgage-backed securities must bear the identical contractual interest rate.
- The mortgage-backed securities must be similar with respect to maturities (expected remaining lives) resulting in approximately the same market yield.
- The mortgage-backed securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
- 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 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 2 (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. 3 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 receipt 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.
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.

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" 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.

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 “collateral”</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:**

<table>
<thead>
<tr>
<th>Cash</th>
<th>1,020</th>
</tr>
</thead>
<tbody>
<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>

<table>
<thead>
<tr>
<th>Securities loaned to broker</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>1,000</td>
</tr>
<tr>
<td>To reclassify loaned securities that cannot be redeemed on short notice</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Money market instrument</th>
<th>1,020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,020</td>
</tr>
<tr>
<td>To record investment of cash collateral</td>
<td></td>
</tr>
</tbody>
</table>

**At conclusion:**

<table>
<thead>
<tr>
<th>Cash</th>
<th>1,025</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>5</td>
</tr>
<tr>
<td>Money market instrument</td>
<td>1,020</td>
</tr>
<tr>
<td>To record results of investment</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Securities</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities loaned to broker</td>
<td>1,000</td>
</tr>
<tr>
<td>To record return of security</td>
<td></td>
</tr>
</tbody>
</table>
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.

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 Manual of the NAIC Securities Valuation Office
- 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.

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

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

¹ Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

² Securities and Exchange Commission, ASR No. 163, Capitalization of Interest by Companies Other Than Public Utilities (Washington: November 14, 1974).
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.\(^3\) If an asset requires a period of time in which to carry out the activities \(^4\) 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 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:

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>LS</td>
<td>loaned or leased to others;</td>
</tr>
<tr>
<td>RR</td>
<td>subject to reverse repurchase agreement;</td>
</tr>
<tr>
<td>DR</td>
<td>dollar repurchase agreement;</td>
</tr>
<tr>
<td>DRR</td>
<td>dollar reverse repurchase agreement;</td>
</tr>
<tr>
<td>C</td>
<td>pledged as collateral;</td>
</tr>
<tr>
<td>DB</td>
<td>placed under option agreement;</td>
</tr>
<tr>
<td>DBP</td>
<td>placed under an option agreement involving “asset transfers with put options”;</td>
</tr>
<tr>
<td>R*</td>
<td>letter stock or otherwise restricted as to sale;</td>
</tr>
<tr>
<td>O</td>
<td>other.</td>
</tr>
</tbody>
</table>

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

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:

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.

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 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.

\[\text{\textsuperscript{1}}\] 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.”

\[\text{\textsuperscript{2}}\] 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.\(^3\)

\[\text{\textsuperscript{3}}\] 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.

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.\(^4\)

\[\text{\textsuperscript{4}}\] "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.
e. 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.

f. 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.
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 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.

   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.

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.”
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 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.

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. Other transfers that are accompanied by an agreement to repurchase the transferred assets 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 Loaned 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

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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Accounting for Investments in Subsidiary, Controlled and Affiliated Entities

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 Manual of the NAIC Securities Valuation Office (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).

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.

20. The statutory accounting principles described in the summary conclusion above reject Accounting Principles Board Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock (APB 18), AICPA Accounting Interpretations, The Equity Method of Accounting for Investments in Common Stock: Accounting Interpretations of APB Opinion No. 18, FASB Technical Bulletin No. 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, and 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. The statutory accounting principles differ from GAAP promulgated as follows:

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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office* 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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, 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 *Purposes and Procedures Manual of the NAIC Securities Valuation Office* 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 Manual of the NAIC Securities Valuation Office* 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, 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, 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.
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<th>Group or Category</th>
<th>Line Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock:</td>
<td></td>
</tr>
<tr>
<td>Parent</td>
<td>0199999</td>
</tr>
<tr>
<td>U.S. Property &amp; Casualty Insurer</td>
<td>0299999</td>
</tr>
<tr>
<td>U.S. Life Insurer</td>
<td>0399999</td>
</tr>
<tr>
<td>Alien Insurer</td>
<td>0499999</td>
</tr>
<tr>
<td>Non-Insurer Which Controls Insurer</td>
<td>0599999</td>
</tr>
<tr>
<td>*Investment Subsidiary</td>
<td>0699999</td>
</tr>
<tr>
<td>Other Affiliates</td>
<td>0799999</td>
</tr>
<tr>
<td>Subtotal - Preferred Stock</td>
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</tr>
<tr>
<td>Common Stock:</td>
<td></td>
</tr>
<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>
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</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 *Purpose and Procedures Manual of
the NAIC Securities Valuation Office*.

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 *Purpose and Procedures
Manual of the NAIC Securities Valuation Office*, 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>0199999</td>
</tr>
<tr>
<td>Common Stock</td>
<td>0299999</td>
</tr>
<tr>
<td>Total - Preferred and Common Stock</td>
<td>0399999</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.

Column 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 from 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. ¹

______________
¹ 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.

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. ²

______________
² See paragraph 9 of this Interpretation for a discussion of such agreements.

   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. ³

______________
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 members 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 Manual of the NAIC Securities Valuation Office, 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 vs. 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.

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.

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.

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.


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>(1) Uninsured Plans</th>
<th>(2) Uninsured Portion of Partially Insured Plans</th>
<th>(3) 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>Group or Category</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>Group or Category</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

Include: 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.

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.
22. *AICPA Statement of Position 78-9, Accounting for Investments in Real Estate Ventures* (SOP 78-9), provides the following guidance:

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.\(^1\) 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
- Issue Paper No. 34—Investment Income Due and Accrued
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 7, Policy Loans, and Chapter 19, Investment Income and Net Realized Gains
- NAIC Annual Statement Instructions, Exhibit 4, Unrealized Capital Gains and Losses on Investments, Exhibit 13, Assets, Exhibit 14 - Analysis of Non-Admitted Assets and Related Items

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 generates 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

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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>
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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:

<table>
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<th>Issue Paper</th>
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<td>Life Contracts</td>
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<tr>
<td>Issue Paper No. 56</td>
<td>Universal Life-Type Contracts, Policyholder Dividends, and Coupons</td>
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<tr>
<td>Issue Paper No. 59</td>
<td>Credit Life and Accident and Health Insurance Contracts</td>
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<td>Issue Paper No. 74</td>
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<td>Property and Casualty Reinsurance</td>
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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>
<td>Issue Paper No. 55</td>
<td>Unpaid Claims, Losses and Loss Adjustment Expenses</td>
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<tr>
<td>Issue Paper No. 66</td>
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<tr>
<td>Issue Paper No. 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 “debit” 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 less premium revenue is recognized. Those estimates are based on assumptions, such as estimated 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
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.

2 Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

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 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.

57. 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 \textit{AICPA Audit and Accounting Guide: Health Care Organizations} provides the following guidance:

\textbf{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;
   
   d. Types of business written;
e. Type of authority granted (i.e., underwriting, claims payment, etc.);

f. 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 uncapped 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\(^1\) 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.

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.

2 Property and liability insurance enterprises, for purposes of this Statement include stock enterprises, mutual enterprises, and reciprocal interinsurance exchanges.

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
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 shot-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

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

Premium deficiency $XX

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 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.

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, 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.

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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.”
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 3 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).

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."

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 4

4 Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

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: 4
a. Payment of the dividend is probable.
b. The amount can be reasonably estimated.

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.)

If 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

4 Accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods.

   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.
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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 statement 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.

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

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
Finalized June 23, 1998

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 (FASB 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;
d. Claim Adjustment Expenses for life entities: Costs expected to be incurred (including legal, investigation, etc.) in connection with the adjustment and recording of life claims in the course of settlement defined in subparagraph 8 b.

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.
- Financial Guaranty contracts are addressed in Issue Paper No. 69—Financial Guaranty Insurance.
- Property and Casualty liabilities subject to discounting are discussed in Issue Paper No. 65—Property and Casualty Contracts.
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 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 unresolved 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.

Inurred 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</th>
<th>COST</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Salaries, including fringe benefits, paid to physician for delivery of medical services;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Capitated payments paid by the HMO to physicians for delivery of medical services to HMO subscribers;</td>
<td></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>
<td></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 withholds from IPAs or are a “risk bonus” in capitate 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.

\[\text{\textsuperscript{4} Certain disclosures are required if the time value of money is considered in estimating liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts (paragraph 60(d)).}\]

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.

\[\text{\textsuperscript{5} Title insurance internal claim adjustment expenses, which generally consist of fixed costs associated with a permanent staff handling a variety of functions including claim adjustment, ordinarily are expensed as period costs because the costs are insignificant.}\]

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*
- *Issue Paper No. 54—Individual and Group Accident and Health Contracts*
- 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;
Universal Life Type Contracts, Policyholders Dividends, and Coupons

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:4

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 devises 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) a change in legal requirements or statutory practices,
b) effects of obsolescence, demand, and other economic factors,
c) actions of competitors and others that may affect competitive advantages,
d) failure to maintain the title plant properly on a current basis, or,
e) 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 actuaries 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 insured 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.  

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.  

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 Issue Paper No. 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.
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.

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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 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. 55.

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.

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...

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
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
casualty insurers. Current disclosure requirements provide regulators with meaningful information with respect to insurer’s reserving practices. Therefore the recording of an arbitrary reserve is no longer justified.

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 a 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:
   
<table>
<thead>
<tr>
<th>Life Insurance Company and Location</th>
<th>Licensed in Company's State of Domicile</th>
<th>Present Value (i.e., Statement Value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Total</td>
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<td>$</td>
</tr>
</tbody>
</table>

b. Instruction:
   If a 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:
   
<table>
<thead>
<tr>
<th>Life Insurance Company and Location</th>
<th>Loss Reserves Eliminated by Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>i. Total</td>
<td></td>
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</table>

44. The NAIC Annual Statement Instructions, Note 19, provide the following guidance with respect to discounting:

19. Discounting of Liabilities for Unpaid Losses or Unpaid Loss Adjustment Expenses
   Instruction:
   State whether or not any of the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted, including liabilities for Workers' Compensation. If the company
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

<table>
<thead>
<tr>
<th>Schedule P Lines of Business</th>
<th>Part I *</th>
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<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
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<tr>
<td>Case</td>
<td>IBNR</td>
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</tr>
<tr>
<td>(1) Homeowner/Farmowners</td>
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<td>(2) Private Passenger Auto</td>
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<tr>
<td>Liability/Medical</td>
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<tr>
<td>(3) Commercial Auto/Truck</td>
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<tr>
<td>Liability/Medical</td>
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<tr>
<td>(4) Workers’ Compensation</td>
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<tr>
<td>(5) Commercial Multiple Peril</td>
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<tr>
<td>(6.1) Medical Malpractice - occurrence</td>
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<tr>
<td>(6.2) Medical Malpractice - claims made</td>
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<tr>
<td>(7) Special Liability</td>
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<tr>
<td>(8.1) Other Liability - occurrence</td>
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<tr>
<td>(8.2) Other Liability - claims made</td>
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<tr>
<td>(9) Special Property</td>
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<tr>
<td>(10) Auto Physical Damage</td>
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<tr>
<td>(11) Fidelity, Surety</td>
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<tr>
<td>(12) Other (including Credit, Accident &amp; Health)</td>
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<tr>
<td>(13) International</td>
<td></td>
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<tr>
<td>(14) Reinsurance A</td>
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<tr>
<td>(15) Reinsurance B</td>
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<tr>
<td>(16) Reinsurance C</td>
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<tr>
<td>(17) Reinsurance D</td>
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<tr>
<td>(18.1) Products Liability - occurrence</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>(18.2) Products Liability - claims made</td>
<td></td>
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<tr>
<td>(19) Financial Guaranty/Mortgage Guaranty</td>
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<tr>
<td>(20) Total</td>
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</tbody>
</table>

* 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

<table>
<thead>
<tr>
<th>Schedule P Lines of Business</th>
<th>Non-Tabular Discount *</th>
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<tbody>
<tr>
<td></td>
<td>(1)</td>
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<tr>
<td></td>
<td>Case</td>
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<td>(4) Workers’ Compensation</td>
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<tr>
<td>(5) Commercial Multiple Peril</td>
<td></td>
</tr>
<tr>
<td>(6.1) Medical Malpractice - occurrence</td>
<td></td>
</tr>
</tbody>
</table>
(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

* 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.

7. Because policy periods do not always correspond to reporting periods and because an insured’s 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 Cl, 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 applying collateral by account. If the insurer is unable to allocate amounts by account, no credit may be taken for collateral.

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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<thead>
<tr>
<th>Insured's Current Quality Rating*</th>
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<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>
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</table>

* 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
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:
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 *Purpose and Procedures Manual of the NAIC Securities Valuation Office* (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)),
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 Manual of the NAIC Securities Valuation Office*, 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;
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 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. 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.1 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.

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.

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.
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 push down 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 Manual of the NAIC Securities Valuation Office
- 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, Poolings 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 Issue 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 Issue 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 Issue No. 90-13, Accounting for Simultaneous Common Control Mergers
- FASB Emerging Issues Task Force Issue 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**
- **FASB Interpretations No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method an interpretation of FASB Statement No. 2**

**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.
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Statutory Issue Paper No. 69

Financial Guaranty Insurance

STATUS
Finalized March 16, 1998

Type of Issue:
Common Area

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>a. Municipal obligation bonds</td>
<td>0.55 percent</td>
</tr>
<tr>
<td>b. Special revenue bonds</td>
<td>0.85 percent</td>
</tr>
<tr>
<td>c. Investment grade Industrial Development Bonds (IDBs) secured by collateral or having a term of seven years or less, and utility first mortgage obligations</td>
<td>1.00 percent</td>
</tr>
<tr>
<td>d. Other investment grade IDBs</td>
<td>1.50 percent</td>
</tr>
<tr>
<td>e. Other IDBs</td>
<td>2.50 percent</td>
</tr>
<tr>
<td>f. Investment grade obligations, secured by collateral or having a term of seven years or less</td>
<td>1.00 percent</td>
</tr>
<tr>
<td>g. Other investment grade obligations</td>
<td>1.50 percent</td>
</tr>
<tr>
<td>h. Non-investment grade consumer debt obligations</td>
<td>2.00 percent</td>
</tr>
<tr>
<td>i. Non-investment grade assetbacked securities</td>
<td>2.00 percent</td>
</tr>
<tr>
<td>j. 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-eightieth 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 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 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 guaranteed 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-eighth 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.
Financial Guaranty Insurance

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
The persistency 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 commute 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)
Policy Acquisition Costs and Commissions

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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